

**The Protection of Shareholders' Rights versus Flexibility in the  
Management of Companies: A Critical Analysis of the Implications of  
Corporate Law Reform on Corporate Governance in South Africa with  
specific reference to protection of shareholders.**

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## **PLAGIARISM DECLARATION**

I hereby declare that this thesis, presented for examination for the degree of Doctor of Philosophy at the University of Cape Town, has not been previously submitted for a degree at this or any other university, that it is my own unaided work both in concept and execution and that all the materials contained herein have been duly acknowledged.

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Signed

Date

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## **ABSTRACT**

In June 2004 the Department of Trade and Industry embarked on a corporate law reform process which culminated in the enactment of the Companies Act 71 2008. One of the key objectives of the reform process was to provide flexibility in the formation and management of companies. As part of this goal, and by the use of the concept of alterable and unalterable provisions, the new Act unravelled some shareholder protective mechanisms provided for under the old Companies Act 61 of 1973. At the same time, it conferred increased powers on the board of directors of a company. These changes affect the power dynamic between shareholders and the board of directors within the company. Given the significant role of directors within the company, these changes give rise to concerns about shareholder protection, especially in the light of the conduct of directors in corporate scandals of the recent past. The objective of this thesis is to show where there has been a shift in the balance of power between shareholders and the board of directors and how this shift affects shareholder protection and, whether the shift of power has been balanced by increased shareholder protection.



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# CHAPTER 1: INTRODUCTION

## 1. Introduction

One of the enduring issues in corporate governance is the so-called agency problem which, in broad terms, refers to the challenge of managing the conflicts of interests that arise ‘whenever the welfare of one party, termed the ‘principal,’ depends upon actions taken by another party, termed the ‘agent.’ The problem lies in motivating the agent to act in the principal’s interest rather than simply in the agent’s own interest.’<sup>1</sup> In the context of corporate governance the agency problem arises from the fact that generally the ownership of the modern public company is divorced from its control and management.<sup>2</sup> The company’s shareholders, who are generally regarded as the owners of the company, are the ‘principals.’ However, due to widely dispersed shareholding in public companies and, for reasons of corporate efficiency, the company is managed and controlled by the directors.<sup>3</sup> In this case the directors are the ‘agents.’

The shareholders expect management to maximise the value of the company for the benefit of the shareholders but, because the directors may have little or no stake in the company, they may not be motivated to maximise shareholder value.<sup>4</sup> If anything, they may be tempted to use their position to benefit themselves at the expense of the shareholders.<sup>5</sup> Hence the agency problem highlights the risk that those entrusted with the power to manage the company may abuse that power to the detriment of the company’s shareholders. The agency problem is at the core of the issues addressed in this thesis relating to the balance of power between the board of directors and the shareholders of a company.

The distribution of corporate power between the two key organs of the company – the board of directors and the shareholders as a body, influences the incidence and severity of the agency problem in any given company. There is a higher risk that an agent in whom wide

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<sup>1</sup> R Kraakman, J Armour, P Davies *et al* *The Anatomy of Corporate Law: A Comparative and Functional Approach* 2ed (2009) at 35

<sup>2</sup> A Berle and G Means *The Modern Corporation and Private Property* 2 ed (1991) (reprint); See also PL Davies ‘The board of directors: composition, structure, duties and powers’ a paper delivered at a conference on *Company Law Reform in OECD: A Comparative Outlook of Current Trends* 7-8 December 2000 Stockholm, Sweden organised by the Organisation for Economic Co-operation and Development (OECD)

<sup>3</sup> T Mongalo ‘The myth of director appointment by shareholders and shareholder activism in listed companies, (2004) 1 *TSAR* 96

<sup>4</sup> *Ibid* at 98

<sup>5</sup> R Kraakman, J Armour, P Davies *et al* *op cit* note 1 ; See also PL Davies ‘The board of directors: composition, structure, duties and powers’ *op cit* note 2 at 2

powers are invested could abuse that power and cause greater harm to the principal than an agent who wields limited power over the principals' affairs.<sup>6</sup> Therefore the division of corporate power is pivotal because it determines the extent to which shareholders of a company are able to exert control over the internal governance of their company,<sup>7</sup> and in doing so constrain the abuse of power by company directors.

It will be shown in this thesis that the old Companies Act 61 of 1973 [hereafter the old Act] did not prescribe how corporate powers were to be distributed between the board of directors and the shareholders in general meeting, thus the common law applied. The common law left the issue of division of corporate powers to be determined by the company's articles.<sup>8</sup> At common law it was generally accepted that if the articles exclusively conferred certain power on the board of directors then only the board could exercise such power and the shareholders in general meeting were precluded from usurping that power.<sup>9</sup> Likewise directors could not usurp the power exclusively conferred by the articles on the general body of shareholders.<sup>10</sup> It was also accepted that where certain powers were not conferred on the board by the Act or, by the company's articles, the shareholders in general meeting had the inherent or residual authority to exercise such power.

The new Companies Act 71 of 2008 [hereafter 'the new Act'] which came into effect on 1 May 2011 significantly changes the internal governance of companies in South Africa. It appears to adopt a new approach regarding the division of corporate powers. The new Act does not leave the division to be determined by the common law but, it appears to make the board the dominant power wielding organ of a company. It expressly confers on the board the power to manage the business and affairs of the company except to the extent that the company's memorandum of incorporation provides otherwise.<sup>11</sup>

The changes brought about by the new Act were in pursuit of the objectives of the law reform process initiated by the Department of Trade and Industry (DTI) in 2003.<sup>12</sup> These objectives were outlined in a policy paper issued by the DTI titled, 'South African Company

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<sup>6</sup> R Kraakman, J Armour, P Davies et al op cit note 1 at 36

<sup>7</sup> FHI Cassim 'The division and balance of power between the board of directors and the shareholders: the removal of directors.' (2013) 29 *Banking Finance Law Review* 151 at 152

<sup>8</sup> MS Blackman, RD Jooste, GK Everingham et al *Commentary on the Companies Act* (2002) Volume 2 at 8 – 293; HS Cilliers, ML Benade, JJ Hening et al *Cilliers and Benade Corporate Law* (2000) 3ed at 86

<sup>9</sup> *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34

<sup>10</sup> *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113 at 114

<sup>11</sup> Section 66(1) of the Companies Act 71 of 2008

<sup>12</sup> T Mongalo 'An overview of company law reform in South Africa: from the guidelines to the Companies Act 2008' (2010) *Acta Juridica* xii

Law for the 21<sup>st</sup> Century,’ [hereafter ‘the DTI paper’].<sup>13</sup> The DTI paper stated that the new company law must ‘promote innovation and investment in South African markets and companies by providing a predictable and effective regulatory environment and flexibility in the formation and management of companies.’<sup>14</sup> In line with this objective the new Act provides flexibility by, inter alia, enabling companies to choose how they wish to organize their internal governance.<sup>15</sup> This is achieved through the use of the concept of ‘alterable provisions.’ An alterable provision is a provision of the new Act in which it is expressly contemplated that its effect on a particular company may be negated, restricted, limited, qualified, extended or otherwise altered in substance or effect by that company’s Memorandum of Incorporation [hereafter MOI].<sup>16</sup>

The emphasis on flexibility is clearly evident in the following statement of Professor Mongalo who headed up the team tasked with devising the new Act. Widening the discretion in the exercise of directors’ power is prominent in this statement:<sup>17</sup>

‘Even though shareholders should be allowed the flexibility to craft a company constitution that addresses their company specific needs, *the fundamental principle that should underlie the corporate decision-making trajectory is that the business and affairs of the corporation should be managed by or be under the direction of the board of directors. In that regard, South African company law should invest the board of directors with wide discretion to make business decisions and a wide choice of means to effect those decisions*, subject to limitations generally acceptable in corporate law circles,’ (writer’s emphasis).

In its pursuit of flexibility the new Act appears to dispense with certain statutory requirements provided for in the old Act.<sup>18</sup> In the process leading up to the enactment of the

<sup>13</sup>Department of Trade and Industry Policy Paper *South African Company Law for the 21<sup>st</sup> Century*. (GN 1183 published in GG 26493 of 23 June 2004) [hereafter ‘the DTI paper’]

<sup>14</sup> ibid at 9; See also Memorandum on the Objects of the Companies Bill, 2008 [B 61- 2008] para 1.1.2(a)

<sup>15</sup> MM Katz ‘Governance under the Companies Act 71 of 2008: flexibility is the keyword’ (2010) *Acta Juridica* 248

<sup>16</sup> Section 1 of the new Act. The section also defines an unalterable provision as, ‘a provision of this Act that does not expressly contemplate that its effect on any particular company may be negated, restricted, limited, qualified, extended or otherwise altered in substance or effect by a company’s Memorandum of Incorporation or rules.’ Despite this definition of an unalterable provision, the effect of s 15(2)(a)(iii) of the Act is such that it also provides some flexibility for a company to include in its MOI a provision, ‘imposing on the company a higher standard, greater restriction, longer period of time or any similarly more onerous requirement, than would otherwise apply to the company in terms of an unalterable provision of this Act.’

<sup>17</sup> T Mongalo ‘An overview of company law reform in South Africa’ op cit note 12 at xxi

<sup>18</sup> In general see for example s 85(1) of the Companies Act 61 of 1973 which required, in respect of share repurchases, that these be authorized in the company’s articles as well as by a special resolution. As will be discussed in detail in the chapter three, generally there are no such requirements in the new Act save for s 48(8) which requires that a share repurchase decision be approved by a special resolution of the shareholders where the shares are to be acquired from inter alia a director or prescribed officer of the company . The new requirements for share repurchases are laid out in s 48 read with s 46 of the new Act.

new Act, the DTI paper questioned the value of some of the statutory requirements in the old Act arguing that, ‘a number of the statutory requirements add unnecessary formalities to relatively simple processes and may be of questionable value, as they do not result in greater protection for shareholders, transparency in the market or enhanced efficiency of enterprises.’<sup>19</sup> While this may have been true concerning some of the provisions of the old Act, it will be shown that the reform process appears to have jettisoned some provisions that were regarded as of paramount importance in the protection of shareholders’ interests such as, for example, the requirement for shareholder approval of share repurchases and share issues.<sup>20</sup>

Therefore the new Act appears to give more power to directors at the expense of shareholder protection. The changes brought about by the new Act affect the power dynamic between shareholders and directors, and raise questions as to whether the Act has struck the right balance between, on the one hand, its objective of attaining flexibility in the management of companies by granting directors a wide discretion and, on the other hand, shareholder protection.

## **1.2 Objectives of the thesis**

In the light of the above, the objective of this thesis is to show where there has been a shift in the balance of power between shareholders and the board of directors and, how this shift affects shareholder protection and, whether the shift has been balanced by increased shareholder protection. In pursuit of this objective the thesis will discuss the following:

- the provisions of the Act which give, or appear to give , increased power to the board;
- if the changes brought about by the new Act affect shareholder protection; and
- whether the shareholder remedies in the new Act adequately protect shareholders in view of the increased powers of the board.

The subject matter of this thesis falls within the ambit of the subject of corporate governance. However, this thesis is not intended to be a broad discourse on corporate governance. Rather, it is limited to a discussion of the provisions of the new Act that influence the balance of power between the board of directors and shareholders of a company, and how this impacts on shareholder protection. This thesis only deals with the protection of shareholders. It does not deal with the protection of other securities holders such as debenture holders. The thesis

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<sup>19</sup> DTI paper op cit note 13 at 15

<sup>20</sup> See for instance FHI Cassim, MF Cassim, R Cassim *et al Contemporary Company Law* 2ed (2012) at 222

is limited to a discussion of the changes brought about by the new Act with regard to the general division of power within the company. It will also focus on the changes made in the area of corporate finance, and how they impact on corporate governance, including the protection of shareholders. The provisions of the new Act that are designed to make directors accountable to shareholders, as well as the provisions designed to encourage shareholder activism will also be considered.

The new Act brought about changes in many other areas apart from those mentioned above. For instance, it brought about changes by introducing the business rescue procedure contained in chapter 6 of the Act. It also brought about changes relating to offers to the public<sup>21</sup>, fundamental transactions such as mergers and amalgamations<sup>22</sup>, disposals of all or a greater part of the assets or the undertaking of a company<sup>23</sup> and schemes of arrangement.<sup>24</sup> It would not be possible to discuss the changes brought about by the new Act in all these areas in a thesis such as this. Although these provisions raise issues of shareholder protection, they are more regulatory in nature in that they largely direct how fundamental transactions should be handled. They are not much concerned with the allocation of power between shareholders and the board of directors and shareholders. Therefore the changes in these other areas will not be discussed.

### **1.3 Relevance of this study**

It appears that in its pursuit of flexibility and efficiency in the management of companies South Africa has, to a certain extent, followed a path similar to that taken by various state jurisdictions in the USA, such as Delaware, New Jersey and Nevada.<sup>25</sup> The development of American corporate law has been described as ‘one of increasing flexibility for directors and decreasing rights for shareholders.’<sup>26</sup> Yet the pursuit of flexibility in American corporate law has not been perceived as a positive development by the majority of academic commentators.<sup>27</sup> Concerns have been raised that it leaves shareholders in a vulnerable position. The trend of giving directors more flexibility in the management of companies

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<sup>21</sup> Sections 95 to 111

<sup>22</sup> Section 113 read with ss 115 and 116

<sup>23</sup> Section 112 read with s 115

<sup>24</sup> Section 114 read with s 115

<sup>25</sup> WL. Cary ‘Federalism and corporate law: reflections upon Delaware’ (1974) 83 *Yale L.J.* 663. See also RK. Winter, Jr. ‘State law, shareholder protection, and the theory of the corporation’ (1977) 6 *The Journal of Legal Studies* 251 at 255

<sup>26</sup> J Velasco ‘The fundamental rights of the shareholder’ (2006) 40 *UC Davis L. Rev.* 407 at 409

<sup>27</sup> RK. Winter, Jr. op cit note 25 at 255-256

while eroding shareholder's rights has famously been labelled as 'the race for the bottom'.<sup>28</sup> Commenting on the trend set by several American states in revising their corporate legislation with the aim of attaining flexibility and efficiency, it has been said that:

'This psychology has been responsible for much of the "modernization" of corporation laws everywhere. Today they are described as "enabling" acts – enabling management to operate with minimum interference. Of course, many of the amendments have been salutary: they have effected simplification and flexibility and have eliminated unnecessary and vestigial procedures. At the same time, however, they have watered the rights of shareholders vis-à-vis management down to a thin gruel.'<sup>29</sup>

The debate generated by the pursuit of flexibility in the United States of America and its impact on corporate governance underscores the importance of interrogating the changes brought about by the new Act, including the impact these changes have on corporate governance in South Africa, in particular on the protection of shareholders.

One of the stated objectives of the new Act is to balance the rights and obligations<sup>30</sup> of shareholders and directors within companies.<sup>31</sup> If, as postulated in this thesis, the new Act gives a wide discretion to directors at the expense of shareholder protection, this would mean that the new Act has an adverse impact on corporate governance in South Africa because it leaves shareholders in a vulnerable position. Effective corporate governance requires a strong legal framework of investor protections.<sup>32</sup> Without a strong legal framework of investor protections the new Act cannot promote the competitiveness and development of the South African economy as envisaged in the DTI paper. Indeed, concerns were raised that the Companies Bill limits the rights of shareholders and that this could make South Africa "notably less attractive" as an investment destination.<sup>33</sup> Therefore this study is important in understanding how the changes brought about by the new Act impact on shareholder protection and, hence corporate governance in South Africa.

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<sup>28</sup> WL. Cary op cit note 25 at 666

<sup>29</sup> *ibid*

<sup>30</sup> It is not clear what 'obligations' means here in relation to the shareholders of a company. It is arguable that since some of the purposes listed in s 7 of the Act include, 'encouraging transparency and high standards of corporate governance...' and to 'encourage the efficient and responsible management of companies,' presumably the shareholders have an obligation to demonstrate responsible shareholding by actively engaging with the company concerning the governance of the company as required by, for example, Principle 2 of the Code for Responsible Investing in South Africa (CRISA) – see the discussion on shareholder activism in chapter 6. However, the Act does not expressly impose such a duty/obligation on shareholders in relation to the company in the way that, for example, s 76 imposes duties on directors of the company.

<sup>31</sup> Section 7(i) of the new Act

<sup>32</sup> SS. Cohen and G Boyd *Corporate Governance and Globalization* 1ed (2000) at 74

<sup>33</sup> A Crotty, "New Law Will Scare off Investors", *Business Report*, available at <http://www.busrep.co.za/index.php?fSetId=662&fSectionId=552&fArticleId=4563936>, accessed on 20 August 2008.

Moreover, major corporate scandals in the recent past both locally and abroad have concentrated the public's attention on the conduct of directors and the internal governance of companies. Corporate scandals abroad involved high profile American companies such as Enron, WorldCom and Arthur Andersen.<sup>34</sup> South Africa too has suffered its own share of corporate scandals involving companies such as, Masterbond, Leisurenet and Fidentia Asset Management.<sup>35</sup> While the causes of the scandals can be attributed to diverse factors, in some cases the boards of directors were partly to blame. For instance, in the Enron and Fidentia cases the respective boards of directors were found to have failed to act with due care and skill in the observance of their duties.<sup>36</sup> It was also found in the Enron case that, 'the independence of the Enron Board of Directors was compromised by financial ties between the company and certain Board members.'<sup>37</sup> In the Fidentia case some of the directors were also found to have had conflicts of interests.<sup>38</sup> In the light of this a question arises as to whether it is desirable to accord directors a wide discretion in the management of companies while seemingly disempowering the company's shareholders as the new Act appears to do.

The purposes of the new Act include, 'to promote the development of the South African economy by *encouraging transparency and high standards of corporate governance as appropriate given the significant role of enterprises within the social and economic life of the nation*,' and also 'to encourage the efficient and responsible management of companies' (writer's emphasis). Therefore this research is valuable because it will highlight any weaknesses in the new Act which impact negatively on corporate governance in South Africa and hence frustrate the realisation of the purposes of the Act.

This study is also important in that it will highlight the extent to which South African corporate law compares with the law in other comparative jurisdictions on the specific issues under discussion in this thesis. This is significant because one of the objectives of the

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<sup>34</sup> JW. Salacuse 'Corporate governance in the new century' (2004) 25 *Company Lawyer* 69

<sup>35</sup> See C Goredema *South Africa: On Pension Fund Plundering Fields* (2007), available at <http://www.issafrica.org/iss-today/south-africa-on-pension-fund-plundering-fields>, accessed on 28 February 2015; S Temkin 'South Africa: Taxing time for boards after corporate scandals' *Businessday* (8 January 2003) Available at <http://allafrica.com/stories/200301080103.html>, accessed 2 March 2012

<sup>36</sup> In the case of Enron see 'The Role of the Board of Directors in Enron's Collapse,' A Report by The Permanent Subcommittee on Investigations of the Committee on Governmental Affairs of the United States Senate (8 July 2002) at 3, available at <https://www.gpo.gov/fdsys/pkg/CPRT-107SPRT80393/pdf/CPRT-107SPRT80393.pdf>, accessed 5 July 2016. In the case of Fidentia Asset Management see the Financial Services Board Inspection Report (FSP No:569) *Fidentia Asset Management (Pty) Ltd* (2007) para 15, available at [http://www.moneyweb.co.za/mw/action/media/downloadFile?media\\_fileid=506](http://www.moneyweb.co.za/mw/action/media/downloadFile?media_fileid=506), accessed on 14 February 2015

<sup>37</sup> See 'The Role of the Board of Directors in Enron's Collapse,' *ibid*

<sup>38</sup> See the Financial Services Board Inspection Report (FSP No:569) *op cit* note 36 at 48



corporate law reform process was to ‘ensure compatibility and harmonisation with best practice jurisdictions internationally.’<sup>39</sup>

Therefore, this thesis does not only contribute to the body of knowledge on corporate governance in South Africa but, it also highlights weaknesses in the new Act and makes recommendations on how the new Act could be improved in order that the objectives of the corporate law reform process may be fully realized.

### ***1.4 Research design and methodology***

This study relies mainly on secondary data in the form of books and journal articles as well as primary sources such as legislation and case law. Other important sources relied on include reports of various committees and commissions, as well as reports of non-governmental organizations. Library and desk-top research are the primary means by which these sources were accessed.

The methodology used in investigating the issues raised in this thesis encompasses various approaches. These include the historical and comparative approaches to research. A critical approach is utilised to analyse the relevant provisions of the new Act and the changes brought about by the new Act. The historical approach is used where knowledge of the historical context of the relevant provision or concept under discussion is crucial to understanding the nature of the changes brought about by the new Act.<sup>40</sup>

In discussing various provisions of the Act this thesis also draws on the experience of other comparative jurisdictions. Hence the comparative approach is used to highlight the similarities and differences between South African law and foreign law and the significance of those differences. The experience of, and developments in other foreign jurisdictions are pertinent to this thesis because, as noted earlier, one of the objectives of the corporate law reform process was to ‘ensure compatibility and harmonisation with best practice jurisdictions internationally.’<sup>41</sup> Moreover, s 5(2) of the Act allows a court to have regard to foreign company law when interpreting any provision of the new Act. Thus a comparative analysis is crucial in understanding the provisions of the new Act.

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<sup>39</sup> DTI paper op cit note 13 at 9

<sup>40</sup> See for example the discussion on the duty of care in chapter four

<sup>41</sup> DTI paper op cit note 13 at 9

The foreign jurisdictions chosen for comparative purposes in this thesis include Canada, England, Australia, New Zealand as well as various states in the United States of America including Delaware, New York and California. The revised Model Business Corporations Act in the USA will also be used for comparative purposes. These jurisdictions have been chosen not only because they are common law jurisdictions like South Africa but, more importantly the law in these jurisdictions influenced the development of the new Act.<sup>42</sup> A comparison with English law is pertinent given that, in the past the development of South African law was largely influenced by English law although this influence has waned, particularly in the new Act. Jurisdictions such as Canada, Australia and Delaware, New York and California were also chosen for comparative purposes because some of the provisions of the new Act are similar to the provisions of the law in one or other of these jurisdictions.<sup>43</sup> For example, in *Mouritzen v Greystones Enterprises (Pty) Ltd and Another*<sup>44</sup> the court noted that s 165 of the new Act, which deals with the derivative action, was modelled on s 237 of the Australian Corporations Act of 2001. A further example, the statutory business judgment rule which was introduced into South African corporate law by the new Act is borrowed from American corporate law.<sup>45</sup>

It is important to note that the approach taken in relation to the comparative aspect is that the legal position in comparative jurisdictions will not be set out separately. Rather, reference to a foreign jurisdiction will be made where appropriate in discussing the relevant provision of the new Act. Discussing the position in comparative jurisdictions separately would make this thesis too long and, in any event is not necessary in a thesis in which so many different aspects are covered.

## **1.5 Structure and overview of thesis**

This thesis is divided into seven chapters and different aspects of the thesis topic are addressed in each of the chapters. Listed below are the chapter headings with a brief outline of the major issues dealt with in each of those chapters.

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<sup>42</sup> DM Davies Book Review of *Contemporary Company Law* by FHI Cassim (Ed) *et al* (2011) 128 SALJ 791

<sup>43</sup> K Van der Linde *Aspects of the regulation of share capital and distributions to shareholders* (unpublished LLD thesis, University of South Africa, 2008)

<sup>44</sup> *Mouritzen v Greystones Enterprises (Pty) Ltd and Another* 2012 (5) SA 74 at 88

<sup>45</sup> The business judgment rule is derived from American case-law and it has been codified in some jurisdictions such as Australia. See DM. Branson 'The rule that isn't a rule – the business judgement rule' (2002) 36 *Valparaiso University Law Review* 631 at 633. Available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=346080&rec=1&srcabs=711122](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=346080&rec=1&srcabs=711122), accessed 20 March 2015. See also FHI Cassim, MF Cassim, R Cassim *et al* *Contemporary Company Law* op cit note 20 at 563

As seen above chapter 1 introduces the research topic and the objectives of the thesis. It provides background information as well as the context or setting of the research problem. It explains the importance of undertaking this research and the research methodology used in examining the research objectives.

#### Chapter 2 –The division of powers within the company

Chapter 2 discusses the changes brought about by the new Act regarding the division of powers between the key organs of the company namely the shareholders as a body and the board of directors. It highlights how the allocation of power is now prescribed in the new Act as opposed to being set out in a company's constitution as was the case under the old Act. The chapter considers whether this default division of powers can be changed by a company's MOI. The power of directors to make rules for the company and to amend the company's constitution is also discussed in this chapter.

#### Chapter 3 – Directors' Powers in the Area of Corporate Finance

Chapter 3 focuses on specific powers of directors regarding certain corporate transactions. The provisions of the new Act which give directors power in relation to the authorisation of shares, share issues, share repurchases and distributions are critically examined and compared with the corporate finance provisions of the old Act in order to highlight the changes brought about by the new Act. The implications of these changes for shareholders are also discussed in this chapter.

#### Chapter 4 –Directors' duties and liability

In the light of the maxim that 'with power comes responsibility' chapter four examines the provisions of the new Act designed to make directors accountable for the exercise of their powers. The duties and liability imposed on directors by the new Act are discussed in this chapter. Also discussed are the related indemnity provisions.

#### Chapter 5 – Remedies: The derivative action and the oppression remedy

Chapter 5 discusses two important shareholder remedies provided for in the new Act namely, the derivative action and the oppression remedy. The chapter discusses the changes in the new Act in relation to these remedies highlighting their strengths and weakness. The importance of these remedies as tools for holding directors accountable is discussed as well as their impact on the balance of power between shareholders and directors.

## Chapter 6 – Other Remedies and the removal of directors

Chapter 6 continues the discussion on shareholder remedies by focusing on other remedies such as, the dissenting shareholders' appraisal remedy and the application to have a director declared delinquent or placed on probation. It also considers the right of shareholders to appoint and remove directors in terms of the Act. The effectiveness of the remedies provided for in the new Act is dependent on whether shareholders make use of them, hence chapter 6 also discusses the problem of shareholder apathy and, how the Act attempts to encourage shareholder activism.

## Chapter 7 – Findings, conclusion and recommendations

Chapter seven concludes the thesis by summarizing the findings of the research. Recommendations on how the Act may be amended to address the shortcomings highlighted by the research are made in this chapter.

## CHAPTER 2: THE DIVISION OF POWERS WITHIN THE COMPANY

### 2.1 Introduction

In pursuit of the objectives of this thesis this chapter examines the changes brought about by the new Act regarding the general division of powers in a company between the board of directors and the shareholders as a body. Also considered in this chapter is the power conferred on the board of directors to amend a company's constitution and to make rules for the company.

When Lord Thurlow noted that a company 'had no soul to be damned and no body to be kicked,'<sup>1</sup> he was alluding to the well accepted concept that a company is a juristic person, consequent to which it cannot act for itself; corporate actions have to be performed through human agents. Amongst other human agents, a company generally acts through two principal organs namely, the shareholders as a body and the board of directors.<sup>2</sup> These two organs play a fundamental role in the governance of a company and the relationship between them is regarded as the most important relationship in the internal corporate structure.<sup>3</sup> Corporate governance is therefore significantly influenced by the distribution of power between these organs.<sup>4</sup>

#### 2.2.1 Division of powers in terms of the old Act

In order to provide context for understanding the changes brought about by the new Act regarding the division of corporate powers this section discusses the legal position prior to the new Act coming into effect.

Generally, the old Act did not stipulate how management powers were to be divided between the board of directors and the shareholders.<sup>5</sup> Hence the division of corporate power was governed by the common law which allowed companies to determine the distribution of

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<sup>1</sup> Edward, First Baron Thurlow 1731-1806 quoted in JC. Coffee Jr. "No soul to damn: no body to kick": an unsandalized inquiry into the problem of corporate punishment' (1981) 71 *Michigan Law Review* 386

<sup>2</sup> HS Cilliers, ML Benade, JJ Henning et al *Cilliers and Benade Corporate Law* (2000) 3ed 84; D Davis, F Cassim, W Geach (eds) et al *Companies and other Business Structures in South Africa* (2009) 61

<sup>3</sup> HS Cilliers, ML Benade, JJ Henning et al op cit note 2

<sup>4</sup> MM Katz 'Governance under the Companies Act 71 of 2008: flexibility is the key word' (2010) *Acta Juridica* 248 at 258

<sup>5</sup> MM Katz op cit note 4

power by virtue of provisions in their articles of association.<sup>6</sup> Most companies adopted article 59 or 60 of tables A and B respectively.<sup>7</sup> Articles 59 and 60 had similar wording and, for present purposes the relevant part of both articles provided that:

'The *business* of the company shall be managed by the directors who... may exercise all such powers of the company as are not by the Act or by these articles required to be exercised by the company in general meeting...'

Therefore, under the old Act the board of directors derived power to manage the business of the company from a company's articles. The power to manage the company's business was effectively delegated by the shareholders to the board of directors by way of a provision in the company's articles.<sup>8</sup> Where certain functions and powers were conferred on an organ such as the shareholders in general meeting or, the board of directors, those functions and powers could be exercised by that organ only.<sup>9</sup> Thus it was accepted that, 'unless the articles of the company expressly so provide, members in general meeting could neither exercise powers conferred upon the directors by the articles nor control the directors' exercise of such powers.'<sup>10</sup> Further, where certain powers were not conferred on the directors, whether expressly or impliedly, by the Companies Act or the company's articles, such powers were considered by the common law to vest in the members in general meeting; in other words shareholders had an inherent, residual or implied power.<sup>11</sup> In *Woolworths Ltd v Kelly* the court said that the primary or, at least, the residual organ for exercising the powers of the company is the shareholders in general meeting.<sup>12</sup>

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<sup>6</sup> MS Blackman, RD Jooste, GK Everingham *et al* *Commentary on the Companies Act* (2002) Volume 2 [Revision Service 6] 8 – 293; Cilliers & Benade *et al* *op cit* note 2 at 86

<sup>7</sup> Tables A and B of Schedule 1 of the old Companies Act 61 of 1973. Table A contained model articles for a public company while Table B contained model articles for a private company. Hence article 59 of table A was adopted by most public companies while most private companies adopted article 60 of table B.

<sup>8</sup> *Louw v Wp Kooperasie Bpk* 1991(3) SA 593 (A) 602.

<sup>9</sup> *Scott v Scott* [1943] 1 All ER 582; Cilliers and Benade *et al* *op cit* note 2 at 87; JJ Du Plessis 'Directors' duty to use their powers for proper or permissible purposes' (2004) 16 *SA Merc LJ* 308 at 311- 312

<sup>10</sup> See MS Blackman 'Article 59 and the distribution of powers in a company' (1973) 90 *SALJ* 262 wherein he discusses, amongst other things, the provisions of article 59 of Table A of the South African Companies Act 61 of 1973 and a line of English cases such as *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 CH 34 (CA) that dealt with the interpretation of a similar provision in the then English Companies Act of 1948. In this particular article MS Blackman questioned this generally accepted view.

<sup>11</sup> MS Blackman, R D Jooste & G K Everingham *et al* *op cit* note 6, Volume 1 at 7 – 19

<sup>12</sup> *Woolworths Ltd v Kelly* (1991) 4 ACSR 431 CA (NSW) 450. See also *Gohlke & Scheneider v Westies Minerale (Edms) Bpk* 1970(2) SA 685 (A); See also *Ben-Tovim v Ben-Tovim* 2001 (3) SA 1074 (C) where the court said that where the directors cannot or will not exercise powers vested in them the general meeting may do so.

### **2.2.2.1 Division of powers in terms s 66(1) of the new Act**

Whereas the old Act did not prescribe how power was to be divided between the shareholders and the board of directors,<sup>13</sup> s 66(1) of the new Act provides that:

‘The business and affairs of a company must be managed by or under the direction of its board, which has the authority to exercise all of the powers and perform any of the functions of the company, except to the extent that this Act or the company’s Memorandum of Incorporation provides otherwise.’

This statutorily defined division of powers is new but not unique to South Africa. Some foreign jurisdictions also have provisions similar to s 66(1). For instance, s 8.01(b) of the US Model Business Corporations Act (hereafter ‘the MBCA’) provides that,

‘All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.’

The Delaware General Corporations Law also provides that, ‘the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.’<sup>14</sup> Canadian law provides that ‘subject to any unanimous shareholder agreement, the directors shall manage, or supervise the management of, the business and affairs of a corporation.’<sup>15</sup> Similarly s 198A (1) and (2) of the Australian Corporations Act provide that,

‘(1) The business of a company is to be managed by or under the direction of the directors.

(2) The directors may exercise all the powers of the company except any powers that this Act or the company’s constitution (if any) requires the company to exercise in general meeting.’

It is pertinent to note that the statutory division of power in the foreign jurisdictions cited above is not absolute. For instance, the division of power in s 8.01(b) of the MBCA is subject to any limitations set in the articles of incorporation or, in a shareholder’s agreement

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<sup>13</sup> MM Katz op cit note 4 at 258

<sup>14</sup> Section 141(a) of the Delaware General Corporations Law. This statute is referenced here because most major publicly traded companies in the US are incorporated in Delaware thus making Delaware an important corporate law jurisdiction for comparative purposes.

<sup>15</sup> Section 102(1) of the Canadian Business Corporations Act (RSC 1985, c C-44)

authorized under s 7.32. Likewise, s 198A (1) and (2) of the Australian Corporations Act is a replaceable rule which may be modified by an appropriately worded provision in a company's constitution. Hence both s 8.01(b) and s 198(A)(1) and (2) are flexible; they allow companies to allocate corporate powers as they deem fit. It is significant that the memorandum on the objects of the Companies Bill, 2008 – which in amended form eventually became the new Companies Act – states that, '*Part F of Chapter 4 presents all matters relating to company governance, introducing changes to enhance flexibility* (writer's emphasis), while retaining much of the existing regime designed to promote transparency and accountability.'<sup>16</sup> Section 66(1) falls under part F of Chapter 4 of the new Act. Therefore, it seems that s 66(1) was introduced not only to align South African law with the law in other industrialised nations but also to enhance flexibility.

Comments by Professor Katz concerning the new Act appear to lend credence to the view that the pursuit of flexibility motivated the changes made by s 66(1).<sup>17</sup> He points out that the introduction of the concept of alterable provisions provides substantial flexibility for companies in regulating their own governance.<sup>18</sup> More importantly, Katz states that the introduction of the concept of alterable provisions in the new Act is Parliament's response to the universal challenge of trying to regulate big and small companies under a single statute.

Section 66(1) is an alterable provision in that it is a provision the language of which expressly contemplates that its effect on a particular company may be negated, restricted, limited, qualified, extended or otherwise altered in substance or effect by that company's Memorandum of Incorporation [hereafter 'MOI'].<sup>19</sup> The flexibility in this case arises from the fact that the company could choose to be governed by the default division of powers in s 66(1) or, it could distribute its power differently by means of a provision in its MOI.

Prima facie, s 66(1) appears to have shifted the balance of power in favour of directors because in the past the default position was that shareholders had original powers but, under s 66(1) the default position is that the board has original power to manage the company's business. Although this may appear to be a shift in the balance of power, it must

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<sup>16</sup> Item 8 of the Memorandum on the objects of the Companies Bill, 2008 [B 61D – 2008]

<sup>17</sup> MM Katz op cit note 4. It is reported that Michael Katz provided some local input to the drafters of the new Companies Act, see P Sutherland 'The state of company law in South Africa' (2012) 1 *Stellenbosch University Law Review* 157 at 158

<sup>18</sup> Ibid

<sup>19</sup> See section 1 of the new Act where an alterable provision is defined as 'a provision of this Act in which it is expressly contemplated that its effect on a particular company may be negated, restricted, limited, qualified, extended or otherwise altered in substance or effect by that company's Memorandum of Incorporation.'



be remembered that the board's power in terms of s 66(1) is subject to what is contained in the MOI hence shareholders have control over the board's power. Moreover, it has been observed that, 'section 66(1) is a codification of what is, and has for many years been, common practice, namely for the shareholders to delegate to the board of directors the power to manage and control the company's business operations...' <sup>20</sup> This view is based on the fact that the wording of section 66(1) is similar to Articles 59 and 60 of tables A and B, by means of which power was delegated to the board under the old Act. <sup>21</sup> Therefore it is submitted that s 66(1) has changed the default position regarding the division powers in a company albeit this default position can be changed by the shareholders via the company's MOI.

It is noteworthy that there are some nuanced differences between the wording of s 66(1) and Articles 59 and 60 of tables A and B. Whereas articles 59 and 60 gave power to the board to manage the *business* of the company <sup>22</sup>, s 66(1) empowers the board to manage the business *and affairs* of the company. In the case of *Ex parte Russlyn Construction (Pty) Ltd* <sup>23</sup> the court had to decide whether a decision taken by a company's directors to liquidate the company, without a shareholder's resolution to that effect, was one taken in the management of the company's business pursuant to the power granted by article 60 of table B. The applicant in that case had argued that a decision to liquidate the company was one taken in the management of its business and was therefore authorised by the articles. Didcott J, rejected the applicant's argument and held that the termination of a company's very existence was not the managing of the business of the company but rather the antithesis of management. He went on to say that in suggesting that the directors' power to manage the business of the company encompasses the power to liquidate the company, the applicant's argument:

'...attaches the wrong label to the power of management. It is a power to manage the company's business. It is not a power to manage the company's 'affairs'. Nowhere does the article refer to the 'affairs' of the company. The word is not used. *Perhaps a power to manage all the 'affairs' of the company would be wider, were it given, than the power to manage the company's business alone.*' <sup>24</sup> (Writer's own emphasis)

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<sup>20</sup> C Stein & G Everingham *The New Companies Act Companies Act Unlocked* (2011) at 222-223

<sup>21</sup> *ibid*

<sup>22</sup> See para 2.2.1 above for a quote of the relevant part of Articles 59 and 60

<sup>23</sup> *Ex parte Russlyn Construction (Pty) Ltd* 1987(1) SA 33 (D)

<sup>24</sup> *ibid* at 36-37; See also *Ex Parte New Seasons Auto Holdings (Pty) Ltd* 2008 (4) SA 341 (W)

The words of Didcott J, quoted above indicate that the power to manage the ‘affairs’ of the company is wider than the power to manage the company’s business alone. Therefore, it has been said that s 66(1),

‘gives the board wider powers than was previously the case... the power extends to both the “business” and the “affairs” of the company. The 1973 Act had no similar provision and the division of powers was regulated in the company’s articles of association, which typically only referred to managing the “business” of the company.’<sup>25</sup>

In the light of the foregoing it is submitted that depending on the provisions of a particular company’s MOI relating to the division of powers, the change brought about by s 66(1) could potentially lead to a shift in the balance of power. If a company’s MOI is silent concerning the division of powers the default position in s 66(1) would apply with the consequence that the board would have the power to manage the business and affairs of the company. And, as noted above, this power is wider than the power granted to boards in terms of articles 59 and 60 of tables A and B of the old Act.

#### **2.2.2.2 Alterability of s 66(1)**

It was noted earlier<sup>26</sup> that s 66(1) is an alterable provision since it authorises the board to exercise all the powers and functions of the company ‘*except to the extent that this Act or the company’s Memorandum of Incorporation provides otherwise*’ (writer’s emphasis). Therefore, it would appear that s 66(1) provides flexibility for shareholders to curb the board’s powers by means of an appropriately worded provision in the MOI.

It is submitted that the extent to which the MOI could curtail the board’s power depends on how the relevant provision in the MOI is drafted. It is noteworthy that in addition to s 66(1), other provisions of the Act expressly and exclusively confer specific powers relating to the management of the company’s business and affairs on the board. For instance, s 46(1)(a)(ii) and s 48(2)(a) expressly empower the board to authorise distributions to shareholders and to authorise share repurchases respectively. Both ss 46 and 48 are unalterable provisions. Therefore it would seem that it would not be permissible for a provision in the MOI to take away the powers expressly conferred on the board by ss 46 and 48. Any such provision in the MOI would be inconsistent with the Act and therefore void in

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<sup>25</sup> See M Havenga ‘Directors’ exploitation of corporate opportunities and the Companies Act 71 of 2008’ (2013) TSAR 257 at 262. See also P Delpont, Q Vorster, D Burdette *et al Henochsberg on the Companies Act 71 of 2008* (Electronic version: Service Issue 11, 2015) at page 250(2)

<sup>26</sup> See para 2.2.2.1 above

terms of s 15(1) of the Act<sup>27</sup> to the extent that it takes away managerial powers which the Act exclusively confers on the board.

Arguably, and at most, it would be permissible to insert a provision in the MOI requiring that any action taken by the directors in the exercise of their powers must be approved by the shareholders.<sup>28</sup> Such a provision would be in accord with s 15(2)(a)(iii) which provides that, the MOI ‘may include any provision imposing on the company a higher standard, greater restriction, longer period of time or any similarly more onerous requirement than would otherwise apply to the company in terms of an unalterable provision of this Act.’ Thus a provision in the MOI may subject some of the board’s management powers to a shareholder veto on the basis of s 15(2)(a)(iii). In certain places the new Act itself subjects some of the board’s power to a veto by shareholders in general meeting. For example, section 115 requires shareholder approval for certain fundamental transactions which the board may propose.

An interesting question is whether, save for those powers expressly and exclusively conferred on the board by provisions of the Act, such as s 46(1)(a)(ii) and s 48(2)(a), the MOI could, or should deprive the board of all the power conferred on it by s 66(1) to manage the business and affairs of the company. Commenting on s 66(1) Delpont *et al* state that, “whether the memorandum of incorporation can exclude all management functions is uncertain. It should be noted that the section places a positive obligation on the directors – i.e. to manage the company.”<sup>29</sup> This statement suggests Delpont *et al* doubt that it would be permissible for a provision in the MOI to take away all managerial power from the board. Their reasoning appears to be that s 66(1) obligates the board to manage the company, therefore taking away all the board’s managerial powers would be inconsistent with the obligation placed on the board. Prima facie, s 66(1) imposes a legal duty on the board to the extent that it provides that, ‘The business and affairs of the company *must be* managed by or under the direction of its board...’ (writer’s emphasis). Focusing on this part of the provision only could lead to the conclusion that this obligation cannot be diminished by a provision in the MOI taking away all the board’s managerial powers. However, it is submitted that it

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<sup>27</sup> Section 15(1) provides that,

(1) Each provision of a company’s Memorandum of Incorporation-

(a) must be consistent with this Act; and

(b) is void to the extent that it contravenes, or is inconsistent with, this Act, subject to section 6(15).

<sup>28</sup> See the discussion in chapter three on distributions

<sup>29</sup> P Delpont *et al Henochsberg on the Companies Act 2008* op cit note 25 at 250(2); See also M Havenga “Directors’ exploitation of corporate opportunities,’ op cit note 25 at 262

would be erroneous to come to this conclusion based on an incomplete reading of s 66(1). To fully understand the import of a provision one must interpret it as a whole and not just focus on a part of it.

When read in its totality it becomes clear that s 66(1) provides that ‘the business and affairs of the company must be managed by or under the direction of the board, which has the authority to exercise all of the powers and perform any of the functions of the company, *except to the extent that this Act or the company’s Memorandum of Incorporation provides otherwise,*’ (writer’s emphasis). Thus even though s 66(1) imposes a duty on the board to manage the business and affairs of the company, and to exercise all the powers of the company, the latter part of the provision acknowledges that the MOI may deprive the board of its management powers. Both the duty and powers of the board in terms s 66(1) are subject to what is provided for in the Act or the MOI.<sup>30</sup>

The question that remains is whether, despite the fact that s 66(1) permits it, the MOI should take away all the board’s managerial powers? It is submitted that there are practical, policy and legal considerations that militate against the MOI taking away all of the board’s managerial powers, especially in the context of widely public companies. From a practical standpoint the question that arises is what purpose would be served by taking away the management functions and powers of the board? If the MOI deprived the board of its powers those powers would of necessity have to be allocated to the shareholders as a body since they constitute an organ of the company. However, the practical and commercial reality, especially in public companies where shares are widely held, is that it is impossible for shareholders to meet frequently for the purposes of passing resolutions in order to exercise day-to-day control over the business and affairs of the company.<sup>31</sup>

Further, because of their professional knowledge, experience and skills in business, directors are usually better placed than most of the shareholders to manage the business and affairs of the company.<sup>32</sup> The general meeting of shareholders makes for an unwieldy

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<sup>30</sup> Delpont *et al* acknowledge that their view to the effect that s 66(1) imposes a positive obligation on the board to manage the company and therefore the MOI cannot take away all of the board’s management functions is debatable. They state that ‘on the other hand it can be argued that s 66 merely regulates the division or allocation of responsibilities between directors and shareholders.’ See P Delpont *et al Henochsberg on the Companies Act 2008* op cit note 25 at 250(2)

<sup>31</sup> A Woo Shun Yun ‘Scope of the general meeting’s power in making management decisions’ Research Paper. Available at <http://lbms03.cityu.edu.hk/oaps/slww2008-4635-wsy357.pdf>, accessed 4 December 2013. See also T Mongalo ‘The myth of director appointment by shareholders and shareholder activism in listed companies’ (2004) 1 TSAR 96

<sup>32</sup> *ibid*

decision making body, comprised of individuals who are likely to have little or no experience in managing a company. On the other hand, the board of directors is a small manageably sized body comprised of individuals with the necessary experience to direct the company. In the widely accepted code of corporate governance principles in South Africa it is stipulated that, ‘the governing body [the board] should serve as the focal point and custodian of corporate governance in the organisation.’<sup>33</sup> Hence a board is needed to manage the business and affairs of the company. That is why under the old Act shareholders routinely delegated the power to manage the business of the company to the board even though the old Act did not prescribe this. Moreover, ‘it is not feasible to place too many restraints on the powers of the board as it is designed to manage the affairs of the company and it can do that effectively only if it is granted a certain degree of independence.’<sup>34</sup> Thus taking away all of the board’s managerial powers would defeat the rationale for appointing a board in the first place.

From a policy perspective it would appear that divesting the board of all its management powers would run contrary to the purposes of the new Act. The Act aims to inter alia, ‘encourage the efficient and responsible management of companies.’<sup>35</sup> Realisation of this aim would be inhibited if the power to manage the business of the company is taken away from the board and invested in the shareholders as a body because as noted above, the shareholders as a body is not an efficient decision making organ.

It is also clear from the words of Prof Mongalo quoted below that one of the underlying policy considerations concerning the division of powers in the new Act was that notwithstanding any flexibility provided for in the Act, ultimately the power to manage the company should reside with the board. Prof Mongalo states that the designers of the guidelines for the corporate law reform process acknowledged inter alia that,<sup>36</sup>

‘Even though shareholders should be allowed the flexibility to craft a company constitution that addresses their company specific needs, the fundamental principle that should underlie the corporate decision-making trajectory is that the business and affairs of the corporation should be managed by or be under the direction of the board of directors. In that regard, South African company law should invest the board of directors with wide discretion to make business decisions and a wide choice of means

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<sup>33</sup> Institute of Directors Southern Africa ‘*King IV Code on Corporate Governance*’ (2016) Principle 6

<sup>34</sup> Cilliers and Benade op cit note 2 at 88

<sup>35</sup> Section 7(j) of the Companies Act 71 of 2008

<sup>36</sup> T Mongalo ‘An overview of company law reform in South Africa: from the guidelines to the Companies Act 2008’ (2010) *Acta Juridica* xii at xxi

to effect those decisions, subject to limitations generally acceptable in corporate law circles.’

In the light of this background information it would seem that a provision in the MOI which takes away the board’s management power and re-allocates it to shareholders would go against the policy consideration underlying the enactment of s 66(1). It is questionable whether a provision in the MOI that takes away all the board’s management powers would, in the words of Prof Mongalo be ‘generally acceptable in corporate law circles.’<sup>37</sup> A different but related question is the extent to which the common law principle that, in the case of a deadlock in the directors’ meeting, powers of management revert by default to the shareholders meeting<sup>38</sup> can be reconciled with s 66(1). It is submitted that this common law principle can and ought to be read into s 66(1) in circumstances where there is deadlock amongst the directors concerning the management of the company. For practical reasons it is imperative that if directors are unable or unwilling to act then another organ – shareholders in general meeting – ought to have residual power to exercise the board’s managerial powers in those circumstances.<sup>39</sup> It is further submitted that reading this principle into s 66(1) where the directors are deadlocked is justifiable on the basis of necessity or business efficacy. Moreover reading the principle into s 66(1) in those circumstances would not be inconsistent with the Act given that s 66(1) is an alterable provision. Of course the power of the shareholders in general meeting to intervene in such circumstances must be read in only to the extent it is necessary to resolve the deadlock and to enable the company to function efficiently. Doing otherwise would not be in accord with the policy considerations referred to in Prof Mongalo’s statement quoted earlier and hence could be considered as being inconsistent with the Act.

Another aspect that militates against the MOI taking away all the managerial powers of the board is the relationship between the exercise of the directorial powers and the observance of the statutory duties of directors. Sections 75 and 76 of the new Act impose a number of duties on company directors. The term ‘director’ is defined in the new Act as including any person occupying the position of a director.<sup>40</sup> It has been observed that the definition of the term ‘director’ in the new Act is wide enough to include both *de jure* and *de facto* directors.<sup>41</sup> It is submitted that if the MOI were to re-allocate the board’s managerial power to shareholders as a body this would result in the shareholders occupying the position

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<sup>37</sup> *ibid*

<sup>38</sup> See *Ben-Tovim v Ben-Tovim* supra note 12 for a statement of this common law principle.

<sup>39</sup> *ibid*

<sup>40</sup> Section 1 of the new Act.

<sup>41</sup> FHI Cassim, MF Cassim, R Cassim *et al Contemporary Company Law* 2ed (2012) at 404

of a director. As such they would be obligated to comply with the statutory duties imposed on directors of a company by the new Act. They would also be at risk of being held liable in terms of s 77 of the new Act for breach of those statutory duties. Apart from this risk, there is also the question of how the reallocation of power could affect the directors' ability to comply with their statutory duties as discussed in paragraph 2.3.3 below.<sup>42</sup>

In the light of the above it would appear that it is undesirable for the MOI of a widely held public company, to take away or, eliminate all the board powers. However the situation is different with regard to small closely held private companies, such as family owned businesses. In such companies the directors and shareholders of the company are usually the same individuals and, it is not unusual for such companies to be run as quasi-partnerships.<sup>43</sup> The default governance arrangement provided for by s 66(1) may not be suitable for such small family owned businesses and therefore there is need to permit such companies to come up with arrangements that suit them. Albeit s 66(1) is alterable, it is debatable whether the boards' powers could be totally excluded by the MOI as observed earlier. It is submitted that there is a practical need to ensure that s 66(1) is worded in such a way that it permits the MOI of a small closely held private company to exclude or eliminate the board's powers. In this regard it is interesting to note the approach in the MBCA regarding the division of powers. As noted in paragraph 2.2.2 above, s 8.01(b) of the MBCA empowers a corporation's board to manage the business and affairs of the corporation 'subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.' Although s 8.01(b) is similar to our s 66(1), it is significantly different in that, in addition to subjecting the board's power to limitations in the articles, s 8.01(b) also provides that the board's power may be limited by a shareholder's agreement. Any limitations to the board's power contained in the articles would have to comply with the MBCA<sup>44</sup> but, notably, a provision in a shareholder's agreement may validly limit the board's power in a manner that is inconsistent with the Model Act. For instance, s 7.32(a)(1); (2) and (8) provide that:

'An agreement among the shareholders of a corporation that complies with this section *is effective among the shareholders and the corporation even though it is inconsistent with one or more other provisions of this Act* in that it:

(1) eliminates the board of directors or restricts the discretion or powers of the board of directors;

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<sup>42</sup> See the discussion in para 2.3.4 below

<sup>43</sup> *Hulett and Others v Hulett* 1992 (4) SA 291 (A) at 307I-308A

<sup>44</sup> Section 2.02(b)(2)(ii) of the MBCA provides that, 'the articles of incorporation may set forth provisions not inconsistent with law regarding managing the business and regulating the affairs of the corporation.'

- (2) governs the authorization or making of distributions whether or not in proportion to ownership of shares, subject to the limitations in section 6.40...
- (8) otherwise governs the exercise of the corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, and is not contrary to public policy.’(writer’s emphasis)

The rationale for allowing a provision in the shareholders’ agreement to limit the board’s power in a manner that is inconsistent with the Act can be gathered from the official commentary on s 8.01(a) of the MBCA which states that,

‘Obviously, some form of governance is necessary for every corporation. The board of directors is the traditional form of corporate governance but it need not be the exclusive form. Patterns of management may also be tailored to specific needs in connection with family controlled enterprises, wholly or partially owned subsidiaries, or corporate joint ventures through a shareholder agreement under section 7.32.’

Hence s 7.32 ensures that companies, especially small closely held private companies, are not shackled by the default division of powers in the MBCA. Companies can easily exclude, restrict or qualify the board’s power by means of a provision in the shareholders’ agreement without being concerned that the provision in the shareholders’ agreement could be declared invalid for being inconsistent with the Model Act. In this regard the MBCA is more flexible than our Act which only allows the board’s powers to be limited by a provision of the MOI in terms of s 66(1). And as observed above, any such provision in the MOI limiting the board’s power must be consistent with the Act otherwise it will be declared invalid in terms of s 15(1) for being inconsistent with the Act. Likewise a similar provision in a shareholder’s agreement would also be void in terms of s 15(7).<sup>45</sup> The possibility that a provision in the MOI or, in a shareholder’s agreement, designed to limit the board’s power may be invalidated for being inconsistent with the Act limits the options available to companies that may wish to alter the default division of powers provided for in the Act. By enacting provisions similar to ss 8.01(a) and 7.32(b) of the MBCA the legislature would provide greater flexibility for companies, particularly small private companies, to establish appropriate governance structures that meet their needs without worrying that provisions in the MOI establishing such arrangements could be invalidated. In this regard it is pertinent to note that the King IV

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<sup>45</sup> Section 15(7) of the Act provides that:

‘The shareholders of a company may enter into any agreement with one another concerning any matter relating to the company, but any such agreement must be consistent with this Act and the company’s Memorandum of Incorporation, and any provision of such an agreement that is inconsistent with this Act or the company’s Memorandum of Incorporation is void to the extent of the inconsistency.’



Report that was issued towards the end of 2016 recognises that organisations, including companies, vary ‘largely in size, resources, extent and complexity of activities.’<sup>46</sup> It notes that appreciating this diversity amongst organisations is important when interpreting and applying the King IV Code on Corporate Governance,<sup>47</sup> [hereafter the King IV Code]. Hence the King IV Code is flexible in that it embraces the philosophy that corporate governance arrangements and practices vary across organisations depending on *inter alia*, their type, size and complexity.<sup>48</sup> It is submitted that in the context of companies this philosophy could be better fostered in the new Act by providing even greater flexibility than is currently provided for by s 66(1), for different types and sizes of companies to establish governance arrangements that are suitable for their circumstances.

Another important issue worthy of discussion regarding the ability of shareholders to control the board’s powers is the question whether shareholders could validly give directions to the board concerning how the latter should exercise the powers conferred on it by the Act. At common law the generally accepted view is that where management power is conferred on the board by a company’s constitution then only the board can exercise those powers.<sup>49</sup> In several cases attempts by shareholders in general meeting to control the board’s management powers by directing the board to act in a particular manner were struck down by the courts.<sup>50</sup> For instance, in *Shaw & Sons (Salford) Ltd v Shaw*<sup>51</sup> a resolution of the shareholders directing the chairman of the board to instruct the company’s lawyers not to proceed with a legal suit was held to be a nullity. The court said that,<sup>52</sup>

‘If powers of management are vested in the directors, they and they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering their articles, or, if opportunity arises under the articles, by refusing to re-elect the directors of whose actions they disapprove. They cannot themselves usurp the powers which by

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<sup>46</sup> Institute of Directors Southern Africa ‘*King IV Report on Corporate Governance for South Africa, 2016*’ Part 6.1 – Introduction to sector supplements

<sup>47</sup> *ibid*

<sup>48</sup> In cognizance of the fact that organisations of different types and sizes face different governance challenges the King IV Report contains ‘Sector supplements’ for specific sectors and categories of organisation. The sector supplements provide high-level guidance and direction on how the King IV Code should be interpreted and applied by a variety of sectors and organisational types. See Part 6 of *King IV Report on Corporate Governance for South Africa, 2016*

<sup>49</sup> MS Blackman ‘Article 59 and the distribution of powers in a company’ *op cit* note 10

<sup>50</sup> See for example *Scott v Scott* *supra* note 9; *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113. See also MS Blackman, RD Jooste, GK Everingham *et al* *op cit* note 6 at 7-14ff where some of these cases are discussed

<sup>51</sup> *Shaw & Sons (Salford) Ltd v Shaw* *ibid*

<sup>52</sup> *ibid* at 134

the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders.’

Similarly, in *Scott v Scott*<sup>53</sup> a resolution of the shareholders in general meeting which could be seen either, as directions to pay an interim dividend or, instructions to make loans was also found to be inconsistent with the company’s articles and declared a nullity. The approach of the court in these and other similar cases led some commentators, in the past, to remark that, ‘the usual provision in the articles that the managerial powers of the board of directors are subject to such regulations as may be prescribed by the company in general meeting is without effect.’<sup>54</sup> However, Blackman argues convincingly that the only possible effect of the words in article 59 of Table A (article 60 of Table B) of the old Act subjecting the directors’ powers of management to, ‘such regulations... as may be prescribed by the company in general meeting,’ is that it permits the shareholders in general meeting to control the directors’ exercise of their power of management by means of an ordinary resolution.<sup>55</sup>

It is noteworthy that in the UK the legislature has tried to side-step the effect of cases such as *Shaw & Sons (Salford) Ltd v Shaw*<sup>56</sup> and also *Scott v Scott*<sup>57</sup> which gave the board’s managerial power pre-eminence over any directions given to the directors by the shareholders in general meeting. This has been done by providing for a default rule in the model articles empowering shareholders in general meeting to direct directors, by way of a special resolution, to take or to refrain from taking specified action.<sup>58</sup> The new South African Companies Act does not have a similar provision. Therefore it would seem that in the absence of any provision to the contrary in a company’s MOI, South African courts are likely to follow the approach in *Scott v Scott* and other similar cases. In other words, the courts are likely to find that unless the MOI of a company provides otherwise, the Act confers the power to manage the business and affairs on the board, therefore only the board can exercise that power. And, the shareholders may not usurp those powers or give directions to the board unless they amend their company’s MOI to include a provision to that effect.

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<sup>53</sup> *Scott v Scott* supra note 9; See also *Australasian Center for Corporate Responsibility v Commonwealth Bank of Australia* [2016] FCAFC 80 in which the court interdicted the holding of shareholder’s meeting called to pass a resolution that would merely make a suggestion to the board of directors on an issue of management.

<sup>54</sup> See Cilliers and Benade op cit note 2 at 86

<sup>55</sup> MS Blackman ‘Article 59 and the distribution of powers in a company’ op cit note 10

<sup>56</sup> *Shaw & Sons (Salford) Ltd v Shaw* supra note 50

<sup>57</sup> *Scott v Scott* supra note 9

<sup>58</sup> UK *Companies Act (Model Articles) Regulations 2008* Schedule 3, regulation 4. (SI 3329 of 2008)

### **2.2.2.3 Alterability of s 66(1) and the interplay with directors' statutory duties**

Another factor that could militate against the ability of shareholders to limit the directors' powers is the relationship between s 66(1) and the statutory directors' duties imposed by s 76(3) of the new Act as well as the liability of directors in terms of s 77 of the new Act. Section 76(3) requires a director of a company,

‘when acting in that capacity, to exercise the powers and perform the functions of a director;

- (a) in good faith and for a proper purpose,
- (b) in the best interests of the company and
- (c) with the degree and of care, skill and diligence....’

Section 77(2)(a) and (b) follows this up by imposing liability on a director in accordance with the principles of common law relating to breach of fiduciary duty or to breach of the duty to act with care and skill.

The challenge is to what extent could the shareholders, by virtue of a provision in the company's MOI negate, restrict or qualify the powers given to directors by s 66(1) without affecting the directors' ability to honour their statutory duties. For instance, if shareholders reserved for themselves power in the MOI to give directions to the board concerning how the latter should exercise its powers, it is conceivable that a direction given by the shareholders on a particular matter may place the directors in a conflicted position if the directors were of the view that the direction by the shareholders was not in the best interests of the company.<sup>59</sup> In such an instance would the directors be obliged to follow the directions given by the shareholders in general meeting as per the company's MOI or, would they be justified in ignoring the directions given by the shareholders and instead, uphold their fiduciary duties to the company?

The answers to the above questions are not clear. It is therefore helpful to learn from the experiences of other jurisdictions that have statutory provisions similar to those of the South African Companies Act. In this regard the Australian experience is relevant. Like the new South African Companies Act, s 198A of the Australian Corporations Act 2001 also

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<sup>59</sup> E Boros ‘How does the division of power between the board and the general meeting operate’ (2010) 31 *Adelaide Law Review* 169 at 172.

confers on the board the power to manage the business<sup>60</sup> of a company while ss 180 and 181 of that Act require the directors to exercise their powers and discharge their duties with due care and diligence and in good faith, in the interests of the company. In an article discussing the division of power between the board and general meeting in the context of the Australian Corporations Act 2001, Elizabeth Boros considers what the position would be if a company's constitution was altered to give shareholders the power to give directions to directors in respect of a particular nominated matter, but the directors were of the view that the directions were not in the best interests of the company.<sup>61</sup>

Boros posits steps in trying to tackle the issue; the first of which is a matter of interpretation whereby one determines whether the direction by the shareholders to the directors is binding on the latter.<sup>62</sup> If the enquiry establishes that the direction was not binding on the directors and the directors opted to abide by that direction, this would not release the directors from the obligation to comply with their statutory duties. In other words, if the directors chose to abide by the direction – which is not binding on them – they could still be found liable for breaching their statutory fiduciary duties. Citing the Australian case of *Capricornia Credit Union Ltd v ASIC*<sup>63</sup> Boros argues that on the one hand, if it was possible to include a provision in the company's constitution – entitling shareholders to give directions to the board, such a provision could arguably also modify the directors' duties to ensure that compliance with the shareholders' directions would not result in breach of duty.<sup>64</sup> She then notes however that, on the other hand, it is not a simple matter to overcome statutory duties.<sup>65</sup> It is submitted, for the reason discussed below, that the same would be true in South Africa in respect of the statutory directors' fiduciary duties.

It is submitted that in South Africa, just like in Australia, the members could not by a resolution adopted by the company, or a provision in the company's MOI, release directors from their fiduciary duties so as to exclude the possibility of the directors being found liable for breach of their duties when acting in compliance with a direction given by the members in general meeting. Section 78(2) of the new Act provides that:

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<sup>60</sup> Section 198A of the Australian Corporations Act 2001 differs from the South African in that it only refers to the business of the company and makes no mention of the 'affairs' of the company.

<sup>61</sup> *ibid* at 170

<sup>62</sup> *ibid*

<sup>63</sup> *Capricornia Credit Union Ltd v ASIC* (2007) 159 FCR 69

<sup>64</sup> E Boros *op cit* note 59 at 170

<sup>65</sup> *ibid*

‘Subject to subsections (4) to (6), any provision of an agreement, the Memorandum of Incorporation or rules of a company, or a resolution adopted by a company, whether express or implied, is void to the extent that it directly or indirectly purports to-

(a) relieve a director of-

(i) a duty contemplated in section 75 or 76; or

(ii) liability contemplated in section 77; or

(b) negate, limit or restrict any legal consequences arising from an act or omission that constitutes wilful misconduct or wilful breach of trust on the part of the director’

In the light of the above, it is submitted that any company that contemplates taking advantage of the so called flexibility of s 66(1) in order to affect the balance of power within the company via a provision in its MOI would have to be very careful in drafting such a provision. The provision in the MOI would have to be drafted in such a way that it would not put directors in a position of conflict. The drafters of the MOI would also have to keep in mind that s 78(2) of the new Act prohibits any provision in the MOI or a resolution of the company relieving directors of their statutory duties. They would also have to ensure that the shareholders in general meeting are not granted extensive powers of direction over the board to control how the latter exercises its managerial powers. Extensive powers of direction could result in the shareholders having to comply with the statutory directors’ duties.

### ***2.3 Directors powers and the company’s constitution and rules***

A consequence of certain of the board of directors’ new found powers is that the board is able to affect the internal governance of the company through its power to amend the MOI and also to make, amend or repeal rules relating to the governance of the company.

Except to the extent that a company’s MOI provides otherwise, s 36(3) and (4) read with s 16(1)(b) empower the board of a company to amend the company’s MOI in such a way as to, *inter alia*, increase or decrease the company’s share capital and, to reclassify any unclassified shares that have been authorised but not yet issued. This is a significant power which enables the board to amend the MOI and to affect the company’s capital structure.<sup>66</sup> Under the old Act the constitution of a company could only be amended by a special resolution of the company’s shareholders.<sup>67</sup>

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<sup>66</sup> See the discussion in chapter three concerning the power conferred on the board of directors by the new Act in the area of corporate finance

<sup>67</sup> See sections 55(1) and 56(4) the old Act concerning alterations to the Memorandum and s62 in relation to alteration of the articles of association.

In addition to the power to amend the company's constitution, the new Act also gives directors the power to make, amend and repeal rules for the company in terms of s 15(3). The rules of a company are meant to regulate any 'matters incidental to the governance of the company' but which are not addressed in the Act or the company's MOI.<sup>68</sup> There are no guidelines in the Act as to what matters are considered 'incidental to the governance of the company.' The term appears to be quite wide, the only qualification being that the rules can only regulate those matters that are not addressed by the Act or the company's MOI. Therefore, the power to make rules for the company is a significant avenue for directors to influence the internal governance of a company. It must be noted though that s 15(3) is an alterable provision; it provides that, '*Except to the extent that a company's memorandum of incorporation provides otherwise*, the board of the company may make, amend or repeal any necessary or incidental rules relating to the governance of the company...' (writer's emphasis). Therefore the company may, in its MOI, preclude this power of directors to make, amend or repeal rules of the company.<sup>69</sup> However, if the MOI is silent concerning the board's power to make rules then the default position in the Act applies with the consequence that the board may make rules for the company. Although the Act gives shareholders power to ratify the rules made by the directors, they are only able to do so at the next general meeting of the shareholders.<sup>70</sup> In the interim period the rules will be binding between the company and each shareholder, between or among the shareholders of the company, between the company and each director, or prescribed officer of the company or any other person serving the company as a member of a committee of the board.<sup>71</sup>

It is noteworthy that the provisions of the Act empowering the board to amend the MOI or make rules of the company are opt-out provisions. That is they apply by default unless a company excludes or limits their application by inserting an appropriate provision in the MOI.<sup>72</sup> This works in favour of the board because the onus is placed on shareholders to take active steps to remove or restrict the board's power. In this respect it would seem that the

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<sup>68</sup> Section 15(3) of the new Act

<sup>69</sup> For example clause 6 of the MOI for Gold Fields Ltd, a JSE listed company, provides that, 'The Board shall not have the capacity to make, amend or repeal any Rules relating to the governance of the Company in respect of matters that are not addressed in the Companies Act or in this MOI, as contemplated in sections 15(3) to (5) of the Companies Act and in the listings requirements of the JSE.' Available at [https://www.goldfields.co.za/reports/ar\\_dec\\_2011/pdf/memo\\_of\\_corp.pdf](https://www.goldfields.co.za/reports/ar_dec_2011/pdf/memo_of_corp.pdf) Accessed on 25 July 2016

<sup>70</sup> Section 15(4)(c)

<sup>71</sup> Section 15(4)(c) (i) & (ii) read with s 15(6) of the new Act.

<sup>72</sup> See s 15(3) in relation to the board's power to make rules and s 36(3) & (4) read with s 16(1)(b) in relation to the board's power to amend the MOI

Act was influenced by the MBCA of which for example, s 10.05(4)(a) and (b) provides *inter alia* that,

*‘Unless the articles of incorporation provide otherwise, a corporation’s board of directors may adopt amendments to the corporation’s articles of incorporation without shareholder approval:*

*(4) if the corporation has only one class of shares outstanding:*

*(a) to change each issued and unissued authorized share of the class into a greater number of whole shares of that class; or*

*(b) to increase the number of authorized shares of the class to the extent necessary to permit the issuance of shares as a share dividend,’ (writer’s emphasis).*

With regard to company rules, s 2.06 of the MBCA empowers the incorporators or the board of directors of a corporation to adopt initial bylaws for the corporation. And, s 10(2)(b)(1) and (2) further provide that:

A corporation’s board of directors may amend or repeal the corporation’s bylaws, unless:

(1) the articles of incorporation or section 10.21 reserve that power exclusively to the shareholders in whole or part; or

(2) the shareholders in amending, repealing, or adopting a bylaw expressly provide that the board of directors may not amend, repeal, or reinstate that bylaw.

It is noteworthy that the MBCA potentially grants wider powers to the board than our Act regarding the making and amending of company rules. This is because the MBCA generally does not require that any bylaws adopted or amended by the board be ratified by the shareholders as is the case under s 15(4)(c) of our Act.<sup>73</sup>

This approach contrasts with the position in the UK where the company’s constitution can only be amended by a special resolution of the shareholders.<sup>74</sup> Likewise in Australia a company constitution may be adopted at the time of registering a company only by persons who have consented to become members of the company<sup>75</sup> or, after incorporation by a special resolution of the company’s shareholders.<sup>76</sup> Further, a company may modify or repeal its constitution, or a provision of its constitution, by a special resolution of the shareholders.<sup>77</sup>

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<sup>73</sup> However s 10.21 of the MBCA limits the board’s power to adopt or amend bylaws increasing the quorum or voting requirements for the board of directors. Our Act has no similar provision.

<sup>74</sup> Section 21(1) of the UK Companies Act 2006

<sup>75</sup> Section 136(1)(a) of the Australian Corporations Act 2001

<sup>76</sup> Section 136(1)(b) of the Australian Corporations Act 2001

<sup>77</sup> Section 136(2) of the Australian Corporations Act 2001

Thus in the UK and Australia only the shareholders have power over the company's constitution.

The South African position is to some extent similar to the position in Delaware although the position in the latter jurisdiction is complicated. The law in Delaware is that *inter alia*, the initial directors of a corporation other than a non-stock corporation or the board of directors of a corporation other than a non-stock corporation which has not yet received any payment for any of its stock may adopt, amend or repeal the original or other bylaws of the corporation.<sup>78</sup> The Delaware Code further provides that after a corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote.<sup>79</sup> Notwithstanding this any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors.<sup>80</sup> Hence in Delaware the law empowers directors prior to the corporation receiving any payment for any of its stock. If the directors do not adopt, amend or repeal the corporation's by-laws in that period the position shifts in favour of the shareholders once the corporation has received payment for any its stock. From then on the power to make and amend the by-laws lies with the shareholders.

The foregoing discussion has shown that the division of powers between shareholders and directors in terms of s 66(1) has the potential to shift the balance of power in favour of directors. If shareholders wish to retain control over the board's power to manage the business and affairs of the company they will have to ensure the company's MOI contains a clause that permits them to do so. If the MOI is silent concerning the board's power, the board will have original power to manage the business and affairs of the company in terms of s 66(1). A comparison with the position in other jurisdiction has shown that the board of directors of a South African company enjoys more statutory power over a company's constitution and rules of the company than boards of directors of companies in the UK, Australia and Delaware.

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<sup>78</sup> Section 109(a) of the Delaware General Corporation law

<sup>79</sup> Ibid

<sup>80</sup> Ibid





## CHAPTER 3: DIRECTORS' POWERS IN THE AREA OF CORPORATE FINANCE

### 3.1 Introduction

The preceding chapter discussed, *inter alia*, the changes made by the new Act concerning the general division of powers within a company as between the board of directors and the company's shareholders in general meeting. This chapter carries the discussion forward by critically examining specific powers conferred on directors in relation to particular company transactions in the area of corporate finance.

In the Department of Trade and Industry's policy paper [hereafter 'the DTI paper'], which laid down the foundation for the corporate law reform process, the term 'corporate finance' is used to refer to 'the area of company law which deals with equity and debt financing of companies, share capital, acquisitions by companies of own shares and financial assistance thereof, share allotments and issue of shares, debentures and restrictions on offering shares for sale.'<sup>1</sup> This is a useful definition but it does not cover corporate distributions apart from share buy backs. For the purposes of this thesis this definition will be adapted to include corporate distributions as these involve the use of the company's assets or funds. The discussion in this chapter considers certain aspects of corporate finance such as the authorization for shares, the directors' power to issue shares, share repurchases and other corporate distributions in respect of which the new Act has brought about changes that directly impact on the balance of power between the board of directors and the shareholders. Other aspects of corporate finance such as debt financing and debentures which do not significantly impact on the balance of power between the board of directors and the shareholders as a body will not be considered.

### 3.2 Authorisation for shares

The authorization of shares is an area in which the new Act has brought about changes. Authorisation for shares is governed by s 36 which is set out below in full for the reader's convenience:

36. Authorisation for shares  
(1) A company's Memorandum of Incorporation-

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<sup>1</sup> Department of Trade and Industry Policy Paper *South African Company Law for the 21<sup>st</sup> Century*. (GN 1183 published in GG 26493 of 23 June 2004) at 32

- (a) must set out the classes of shares, and the number of shares of each class, that the company is authorised to issue;
  - (b) must set out, with respect to each class of shares-
    - (i) a distinguishing designation for that class; and
    - (ii) the preferences, rights, limitations and other terms associated with that class, subject to paragraph (d);
  - (c) may authorise a stated number of unclassified shares, which are subject to classification by the board of the company in accordance with subsection (3)(c); and
  - (d) may set out a class of shares-
    - (i) without specifying the associated preferences, rights, limitations or other terms of that class;
    - (ii) for which the board of the company must determine the associated preferences, rights, limitations or other terms; and
    - (iii) which must not be issued until the board of the company has determined the associated preferences, rights, limitations or other terms, as contemplated in subparagraph (ii).
- (2) The authorisation and classification of shares, the numbers of authorised shares of each class, and the preferences, rights, limitations and other terms associated with each class of shares, as set out in a company's Memorandum of Incorporation, may be changed only by-
- (a) an amendment of the Memorandum of Incorporation by special resolution of the shareholders; or
  - (b) the board of the company, in the manner contemplated in subsection (3), except to the extent that the Memorandum of Incorporation provides otherwise.
- (3) Except to the extent that a company's Memorandum of Incorporation provides otherwise, the company's board may-
- (a) increase or decrease the number of authorised shares of any class of shares;
  - (b) reclassify any classified shares that have been authorised but not issued;
  - (c) classify any unclassified shares that have been authorised as contemplated in subsection (1)(c), but are not issued; or
  - (d) determine the preferences, rights, limitations or other terms of shares in a class contemplated in subsection (1)(d).
- (4) If the board of a company acts pursuant to its authority contemplated in subsection (3), the company must file a Notice of Amendment of its Memorandum of Incorporation, setting out the changes effected by the board.

Section 36(1)(d), read with s 36(3)(c) invests in the board of directors the power to classify any unclassified shares into one or more existing classes of authorised shares. Further, section 36(1)(d), read with section 36(3)(d), of the new Act invests the board with power to determine the rights attaching to the class of shares envisaged by s 36(1)(d). Effectively this empowers the directors to create a new class of shares.<sup>2</sup>

In this regard s 36(1)(d) read with s 36(3)(d) appear to have been influenced by s 6.02 of the MBCA which provides as follows:

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<sup>2</sup> C Stein & G Everingham *The New Companies Act Companies Act Unlocked* (2011) at 155. Such shares have been described as 'blank cheque stock' by Hanks who explains that, 'blank cheque stock was developed in the US over 20 years ago and has proven to be extremely useful to companies in rapidly raising capital in time-sensitive, highly competitive global financial markets without the need for the time consuming process of obtaining shareholder approval...' See JJ. Hanks, Jr 'The new legal capital regime in South Africa' (2010) *Acta Juridica* 131 at 145

- (a) If the articles of incorporation so provide, the board of directors is authorized, without shareholder approval, to:
  - (1) classify any unissued shares into one or more classes or into one or more series within a class,
  - (2) reclassify any unissued shares of any class into one or more classes or into one or more series within one or more classes, or
  - (3) reclassify any unissued shares of any series of any class into one or more classes or into one or more series within a class.
- (b) If the board of directors acts pursuant to subsection (a), it must determine the terms, including the preferences, rights and limitations, to the same extent permitted under section 6.01, of:
  - (1) any class of shares before the issuance of any shares of that class, or
  - (2) any series within a class before the issuance of any shares of that series.

Thus the MBCA, like our new Act, authorizes the board to create a new class of shares by reclassifying any unissued shares of any class into one or more classes and to determine the rights and preferences attaching to that new class. To the extent that ss 36(1)(c) and (d) of the new Act invests power in the board to create a new class of shares and, to determine the rights attaching to any shares without further reference to shareholders for approval, these provisions constitute a fundamental departure from the position under the old Act.<sup>3</sup> In terms of s 75 of the old Act the creation of any shares and the determination of rights attaching to any shares had to be authorised by the company's articles and by a special resolution of the shareholders.<sup>4</sup>

Apart from the changes relating to the authorization of shares, the new Act has also brought about changes regarding the power to amend the MOI, in particular the provisions of the MOI relating to the number of authorized shares and the rights attaching to shares. There are two different ways in which the authorization and classification of shares, the number of authorised shares of each class, and the rights associated with each class of shares may be changed.<sup>5</sup> One way of effecting the change is by way of an amendment to the MOI pursuant to a special resolution of the shareholders.<sup>6</sup> The other way is by means of a resolution of the company's board of directors in terms of s 36(2)(b). The essence of ss 36(2)(b) and (3) is that unless a company's MOI provides otherwise, the company's directors are empowered to change the number of authorised shares of any class, the class(es) into which the company's shares are divided into, and the rights attaching to those shares. In other words, to the extent that a company's MOI does not provide otherwise, the new Act invests directors with the

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<sup>3</sup> C Stein & G Everingham op cit note 2

<sup>4</sup> Section 75(1)(a) – (i) of the old Act

<sup>5</sup> Section 36(2) of the new Act

<sup>6</sup> Section 36(2)(a) of the new Act

power to alter the nature and number of a company's authorised shares without further reference to the company's shareholders. This contrasts with the position under s 75 of the old Act where a company could only alter its share capital if it was authorised to do so by its articles and by special resolution of the shareholders. Sections 36(2)(b) and (3) may have been influenced by s 10.05(4)(a) and (b) of the MBCA which empowers the board of a company that has only one class of shares outstanding to amend the company's constitution in order to:

- (a) change each issued and unissued authorized share of the class into a greater number of whole shares of that class or,
- (b) to increase the number of authorized shares of the class to the extent necessary to permit the issuance of shares as a share dividend.

The concept of a company having authorized capital serves to *inter alia*, protect shareholders against dilution of their shareholding in the company.<sup>7</sup> In terms of the old Act the measure of protection enjoyed by shareholders against possible dilution of their shareholding was enhanced by the fact that shareholders wielded a veto power over any proposed changes to the company's share capital. The old Act provided that a company having a share capital could, by way of a special resolution and if so authorized by its articles, increase its share capital, subdivide its shares or convert its ordinary or preference share capital.<sup>8</sup> This meant the company's share capital could not be altered without shareholder approval. In terms of the provisions of the new Act referred to above, the possibility now exists that directors may alter the company's share capital without reference to shareholders. It is submitted that this possibility represents a potential shift in power unless of course the MOI precludes the board from having such power as discussed below.

Both ss 36(2)(b) and (3) are alterable provisions. Therefore the MOI of a company may alter the effect of these provisions. For instance, the MOI could negate the effect of s 36(2)(b) by expressly excluding the board's power to increase or decrease the authorised shares. Consequent to this the company would then only be able to alter its authorized capital by means of a special resolution of the company's shareholders as provided for in s 36(2)(a). Shareholders would thus be in a position to protect their interests since they, and not the board, would have the power to alter the company's authorised capital.

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<sup>7</sup> K Van der Linde 'The regulation of share capital and shareholder contributions in the Companies Bill 2008' (2009) *TSAR* 39 at 44

<sup>8</sup> Section 75(1)(a)(i) of the Companies Act 61 of 1973 [ hereafter 'the old Act']

While ss 36(2)(b) and (3) are alterable, deliberate action on the part of the company's shareholders is required to amend the MOI in order to exclude the board's power to alter the company's authorized share capital. If a company's MOI is silent on the matter the default position provided for in the Act prevails. It is submitted that whether the shareholders of a particular company will be able to amend the company's MOI in order to exclude the board's power depends largely on the nature and voting power of the dissatisfied shareholders.

If the shareholding mainly consists of unsophisticated shareholders it is highly unlikely that they would be pro-active enough to examine the company's constitution, let alone initiate the required changes. On the other hand if the shareholding consists largely of institutional investors, such shareholders are likely to be sophisticated and pro-active enough to be able to initiate and carry through the necessary changes.<sup>9</sup> However, even if the average individual investor was sophisticated, pro-active and motivated enough to read the company's MOI, it may be another matter altogether for that shareholder to have the requisite voting power to pass a special resolution to amend the company's MOI.<sup>10</sup> In terms of s 16(1)(c)(i)(bb) of the new Act the shareholder would only be able to propose a special resolution to amend the MOI if he was entitled to exercise at least 10% of the votes that may be exercised on such a resolution.<sup>11</sup>

In the light of the above s36 of the new Act potentially shifts the balance of power in favour of directors by making it possible for directors to alter the company's share capital without reference to shareholders. This does not bode well for shareholder protection and good corporate governance.

### **3.3 Issuing of shares**

The preceding section considered the changes made by the new Act in relation to the authorization of shares. The decision to issue the authorized shares is also regulated by company law.<sup>12</sup> This section highlights certain problems associated with the issuing of

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<sup>9</sup> For a discussion of the influence of institutional shareholders on corporate governance see BS. Black 'Shareholder passivity re-examined' (1990) 89 *Michigan Law Review* 520 at 570ff

<sup>10</sup> In terms of s 16(11)(a) of the new Act a special resolution is required to amend the company's MOI to the extent required by ss 16(1)(c) and 36(2)(a). Generally, in terms of 65(9) of the Companies Act 71 of 2008 a special resolution must be supported by 75% of the voting rights exercised on the resolution. (This threshold may be changed in terms of s 65(10) of the Act). Thus it may not always be easy for a shareholder to get a company to amend its MOI so as to counter the effects of ss 36(2)(b) and (3) of the new Act.

<sup>11</sup> The 10% threshold with respect to proposals for MOI amendments may be changed by the company's MOI in terms of s 16(2) of the new Act

<sup>12</sup> See s 36 and 38 of the new Act concerning authorisation and issuing of shares respectively.

shares. Thereafter the regulation of share issues in terms of the old as well as the new Act will be discussed.

Directors can abuse the power to issue shares for diverse reasons.<sup>13</sup> These include for example the dilution of the ownership of existing shareholders and, entrenchment of directors on the board.<sup>14</sup> In *Fraser v Whalley*<sup>15</sup> the directors of the company were facing removal from office at the next annual general meeting. To prevent their removal the directors, acting on the basis of an obsolete power entrusted upon them for a different purpose, resolved to issue shares of the company for the purpose of controlling the annual general meeting at which the directors' fate was to be decided. A minority shareholder applied to court for an injunction to restrain the issue of such shares. The court granted the injunction and held that where directors clandestinely, and at the last moment, use a stale resolution for the express purpose of preventing the free action of shareholders the court would intervene to prevent so gross a breach of trust.<sup>16</sup> Although the directors in *Fraser v Whalley* failed in their bid, the case illustrates the potential for abuse of power by directors who are eager to retain office.<sup>17</sup>

Apart from misusing the power to issue shares to keep themselves in office and to change or create a majority, directors may also misuse the power to frustrate a take-over bid.<sup>18</sup> This was the case in *Hogg v Cramphorn Ltd and Others*.<sup>19</sup> In that case the articles of the company placed the shares of the company under the control of the directors who were invested with the power to allot or dispose of the shares on such terms and conditions as the directors thought fit. A Mr. Baxter made a take-over bid for Cramphorn Ltd. The directors of the company believed the take-over was bad for the company. They acted to prevent the takeover by issuing shares with special voting rights of ten votes per share to a trust created for the benefit of the company's employees; some of the directors were trustees of the trust and the share issue effectively put them in a position to outvote the take-over bid. The court found that the purpose of this scheme was to ensure control of the company by the directors and those whom they could confidently regard as their supporters. It held that the share issue

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<sup>13</sup> See, J Kiggundu 'The control of the directors' power to allot shares' (1993) 5 *Afr. J. Int'l & Comp. L.* 260 at 261.

<sup>14</sup> R Kraakman, J Armour & P Davies *et al The Anatomy of Corporate Law-A Comparative and Functional Approach* 2 ed (2009) at 192-193. See also John Kiggundu op cit note 13

<sup>15</sup> *Fraser v Whalley* (1864) 2 Hem. & M.10; 71 E.R. 361

<sup>16</sup> *Ibid* at 369

<sup>17</sup> John Kiggundu op cit note 13 at 261

<sup>18</sup> *ibid* at 264

<sup>19</sup> *Hogg v Cramphorn* [1967] Ch 254

amounted to an improper exercise by the directors of their fiduciary power to issue shares and thus should be set aside.

The cases discussed above illustrate some of the problems attendant upon giving the power to issue shares to directors. In the light of these problems and for the protection of shareholders' interests, it becomes crucial for any system of corporate governance to regulate the power to issue shares by *inter alia*, providing a system of checks and balances to prevent the abuse of the power to issue shares.

### **3.3.2. Authority to issue shares under section 221 of the Companies Act 61 of 1973**

The relevant section under the old Act regarding the issuing of shares was s 221(1) which provided that,

‘Notwithstanding anything contained in its memorandum of articles, the directors of a company shall not have the power to allot or issue shares of the company without the prior approval of the company in general meeting.’

The section required directors to seek shareholder approval before they could issue any shares. Hence shareholders enjoyed a veto power over the board's decision to issue shares. It is submitted that this served to prevent abuse of the power to issue shares. Section 221 was a preventative measure which empowered shareholders to protect their interests before any harm could be done by directors acting in their own selfish interests. If the shareholders were of the view that a share issue proposed by the directors could be harmful to their interests, the shareholders were in a position to prevent such a share issue without having to go to court for an injunction to prevent the share issue. All the shareholders had to do was to withhold their approval for such a share issue.

Section 221(1) was reinforced by s 221(4). In terms of s 221(4) any director who knowingly took part in the allotment or issue of any shares in contravention of s 221(1) was liable to compensate the company for any loss, damages or costs which the company may have incurred or sustained as a result of the unauthorized allotment or issue of shares. This, and the liability of directors in terms of the common law for breach of their fiduciary duties, enhanced the protection enjoyed by shareholders against directors' self-interested actions.

If shareholders gave their approval for directors to issue shares as envisaged by s 221, the old Act had another veneer of protection. The approval could have taken one of two forms. It could have been in the form of a general authority to the directors to issue any shares in their discretion or, it could have been in the form of a specific authority in respect of



any particular allotment or issue of shares.<sup>20</sup> In the latter case the likelihood of abuse by directors of their power to issue shares was very remote given that the share issue would have been authorized for a specific purpose and the directors enjoyed no discretion in that regard. A greater possibility of abuse was present in the case of an approval given as a general authority to issue shares because then the directors had a degree of discretion in the matter and thus could use the general authority to further their own interests instead of advancing the interests of the shareholders. However, the scope of abuse was, to some extent, limited by the fact that the general authority was not one that endured indefinitely; if the approval was given as a general authority, such approval was valid only until the next annual general meeting of the company and the general authority could also be varied or revoked by any general meeting of the company prior to the next annual general meeting.<sup>21</sup> Thus s 221 put shareholders in a position to control the use of the power to issue shares by company directors thereby empowering the shareholders to protect their interests. However, as noted above, there was very little protection for shareholders where a general approval was granted because there was scope for abuse while the authority lasted.

The rationale behind the enactment of s 221 of the old Act is noteworthy. The section was enacted following recommendations from the Van Wyk de Vries Commission which pointed out that,

‘[T]here was a strong body of opinion to the effect that directors should not have unlimited powers, whether derived from the articles or a resolution by the company in meeting to issue shares. The issue by the company of further shares is a matter which directly affects the interests of each holder of shares in that company... There seems to be justification for imposing a curb on unlimited powers of directors in this respect...’<sup>22</sup>

In the light of the above statement it is reasonable to conclude that the restriction imposed by s 221 on the directors’ powers to issue shares was introduced to protect the interests of shareholders. The general body of opinion at the time was that the issue of further shares by a company was a transaction that directly impacted on shareholders’ interests and thus it was crucial to give shareholders a say on the matter.<sup>23</sup>

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<sup>20</sup> Section 221(2) of the old Act

<sup>21</sup> Section 221(3) of the old Act

<sup>22</sup> *Commission of Enquiry into the Companies Act* Main Report RP 45/1970 para 44.40 and recommendation 101. See also MS Blackman, RD Jooste & GK Everingham *et al* *Commentary on the Companies Act* (2002) Volume 2 at 8-292-3

<sup>23</sup> *Commission of Enquiry into the Companies Act* *ibid*

Section 222 of the old Act also governed the issue of shares and debentures to directors. It provided as follows:

(1) No provision in any memorandum or articles or in any resolution of a company authorizing the directors to allot or issue any shares or debentures convertible into shares of the company at the discretion of the directors, shall authorize the allotment or issue of any such shares or debentures to any director of the company or his nominee, or to any body corporate which is or the directors of which are accustomed to act in accordance with the directions or instructions of such director or nominee, or at a general meeting of which such director or his nominee is entitled to exercise or control the exercise of one-fifth or more of the voting power, or to any subsidiary of such body corporate unless-

(a) the particular allotment or issue has prior to the allotment or issue been specifically approved by the company in general meeting; or

(b) such shares or debentures are allotted or issued under a contract underwriting such shares or debentures; or

(c) such shares or debentures are allotted or issued in proportion to existing holdings, on the same terms and conditions as have been offered to all the members or debenture-holders of the company or to all the holders of the shares or such debentures of the class or classes being allotted or issued; or

(d) such shares or debentures are allotted or issued on the same terms and conditions as have been offered to members of the public.

The restriction in s 222 was much wider than s 221 in that it related not only to the issue of shares, but also to the issue of debentures convertible into shares of the company.<sup>24</sup> The restriction in s 222 regulated the allotment or issue of shares or debentures convertible into shares where directors were likely to have a conflict of interest. Section 222(1)(a) required that in such instances the allotment or issue be specifically approved by the company in general meeting. In this respect s 222 is similar to s 41(1) of the new Act to the extent that the latter requires shareholder approval for *inter alia*, an issue of shares or securities convertible into shares where the shares or securities are to be issued to, amongst others, a director, prescribed officer of the company<sup>25</sup> or, to a person related or interrelated to the company.<sup>26</sup> It must be noted though that s 222(a) only required an ordinary resolution in such instances whereas s 41(1) requires a special resolution as discussed in paragraph 3.3.3 below.

Section 222 did not require shareholder approval where directors were unlikely to act in their own interest at the expense of shareholders such as for example, where the shares or debentures were allotted or issued on a prorated basis and, on the same terms and conditions as had been offered to all the members or debenture-holders of the company or, to all the

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<sup>24</sup> P Delpont 'Share issues and shareholder protection' (2013) 4 *De Jure* 1056 at 1057

<sup>25</sup> Section 41(1)(a) of the new Act

<sup>26</sup> Section 41(1)(b) of the new Act

holders of the shares or such debentures of the class or classes being allotted or issued.<sup>27</sup> Likewise s 41 does not require shareholder where the directors are not likely to be influenced by a conflict of interest such as for example, when the issue of shares or securities is in proportion to existing holdings, and on the same terms and conditions as have been offered to all the shareholders of the company or to all the shareholders of the class or classes of shares being issued.<sup>28</sup>

### **3.3.3 Authority to issue shares under section 38 of the new Companies Act 71 of 2008**

Under the new Act the issuing of shares is governed by section 38 which provides that,

‘The board of a company may resolve to issue shares of the company at any time, but only within the classes, and to the extent, that the shares have been authorized by or in terms of the company’s Memorandum of Incorporation, in accordance with section 36.’<sup>29</sup>

Unlike s 221(1) of the old Act, no shareholder approval is required in terms of s 38(1) of the new Act. There are only a few prescribed instances in which directors are required to seek shareholder approval to issue shares in terms of the new Act. These are laid down in s 41(1)(a)-(c) which provides that an issue of shares or securities convertible into shares, or a grant of options, or a grant of any other rights exercisable for securities, must be approved by a special resolution of the shareholders of a company if the shares, securities, options or rights are issued to specified classes of people who include, amongst others, directors or future directors of the company or any persons related or inter-related to such directors or the company or a nominee of the afore-mentioned persons.<sup>30</sup> Section 41(3) also provides that:

‘An issue of shares, securities convertible into shares, or rights exercisable for shares in a transaction or a series of integrated transactions requires approval of the shareholders by special resolution if the voting power of the class of shares that are issued or issuable as a result of the transaction or series of integrated transactions will be equal to or exceed 30% of the voting power of all the shares of that class held by shareholders immediately before the transaction or series of transactions.’<sup>31</sup>

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<sup>27</sup> Section 222(1)(c) of the old Act

<sup>28</sup> Section 41(2)(c) of the new Act

<sup>29</sup> Section 38(1)

<sup>30</sup> Sections 41(1)(a) – (c) of the new Act

<sup>31</sup> Section 41(3) of the new Act

By empowering the board to issue shares without shareholder approval the approach in the new Act is in line with jurisdictions such as Australia where, unless the company's constitution provides otherwise, a company's power to issue shares is also exercised by the board of directors.<sup>32</sup> The MBCA also invests the power to issue shares in the board of directors.<sup>33</sup> However section 6.21(a) of the MBCA also provides that the powers granted to the board of directors to issue shares may be reserved to the shareholders by the articles of incorporation. Hence the MBCA, unlike our new Act provides flexibility for shareholders to retain control over the power to issue shares. The only instance where shareholder approval is required to issue shares under the MBCA is in terms of s 6.21 (f) which provides that an issuance of shares or other securities convertible into or rights exercisable for shares, in a transaction or a series of integrated transactions, requires approval of the shareholders if the shares, other securities, or rights are issued for consideration other than cash or cash equivalents, and the voting power of shares that are issued and issuable as a result of the transaction or series of integrated transactions will comprise more than 20 percent of the voting power of the shares of the corporation that were outstanding immediately before the transaction.

Section 6.21(f) of the MBCA is similar to s 41(3) of our Act which also requires shareholder approval in similar circumstances. However, shareholder approval would only be required in terms of s 41(3) if the voting power of shares that are issued will be equal to or exceed 30% of the voting power of all the shares of that class held by shareholders immediately before the transaction or series of transaction. Thus our Act sets a higher threshold of voting power that would trigger the requirement for shareholder approval. In this respect our Act offers weaker protection to shareholders than the MBCA. However our Act better protects shareholders than the MBCA in another respect because it also requires shareholder approval where shares are issued to *inter alia*, directors and prescribed officers of the company or persons that are related to them as discussed earlier.

Apart from empowering directors to issue shares without further reference to shareholders, the provisions of the new Act make it possible for directors to get away with issuing shares that are not authorized in accordance with the provisions of the Act or which are in excess of what is authorized in the company's MOI. Section 38(2)(a) and (b) provide that,

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<sup>32</sup> Section 124(1)(a) read with s 198A(2) of the Australian Corporations Act

<sup>33</sup> Section 6.21(b) of the Model Business Corporations Act

‘If a company issues shares –

- (a) that have not been authorized in accordance with section 36; or in excess of the number of authorized shares of any particular class,
- (b) *the issuance of those shares may be retroactively authorized in terms of s 36 within 60 business after the date on which the shares were issued.*’ (Writer’s emphasis)

It will be recalled that s 36 of the new Act provides *inter alia*, that the authorization for shares and the numbers of authorized shares of each class may be changed by either, an amendment to the MOI pursuant to a special resolution of the shareholders or, except to the extent that the MOI provides otherwise, by an amendment to the MOI made by the directors.<sup>34</sup> It follows from this that not only is the board of directors empowered to issue shares without reference to shareholders in terms of s 38(1), but in terms of s 38(2) read with ss 36(2), (3) and (4), the directors can also potentially get away with issuing shares in excess of what is authorised in the company’s MOI. They can do this by retroactively authorizing the shares by way of an amendment to the MOI in accordance with s 36. The directors’ power in this regard represents a new and extraordinary power which directors did not have under the old Act.

In the light of the above it is submitted that s 38(1) of the new Act represents a fundamental shift from the position under s 221(1) of the old Act. Presumably it is part of the changes designed to provide flexibility for companies in the area of corporate finance as envisaged in the DTI Policy paper.<sup>35</sup> While it is acknowledged that dispensing with the requirement for shareholder approval in the context of issuing shares affords company management a measure of flexibility when raising finance for the company, dispensing with the requirement takes away the protection accorded to shareholders by s 221 of the old Act. This radical shift in position has been questioned especially given the genesis of s 221.<sup>36</sup>

It is submitted that in the context of corporate governance both shareholder protection and flexibility in the management of companies are valid and important considerations; to prefer one over the other calls for a value judgment based on a weighing of the two. Therefore, the apparent paring away, by s 38(1) of the new Act, of the shareholder protection afforded by s 221 of the old Act, would be justified if, in the end, the benefits of granting flexibility to directors to issue shares without seeking shareholder approval would outweigh the apparent loss of shareholder protection as encapsulated in s 221 of the old Act.

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<sup>34</sup> Sections 36(2), (3) & (4) of the new Act

<sup>35</sup> DTI paper op cit note 1 at 32

<sup>36</sup> FHI Cassim, MF Cassim & R Cassim *et al Contemporary Company Law* 2ed (2012) at 222

The shift would also be justifiable if the other measures for protecting shareholders in the new Act provide the required balance. In this respect one of the protective measures provided for in the Act is the requirement for approval by way of a special resolution of the company's shareholders of certain share issues that present a high risk for shareholders.<sup>37</sup> As observed earlier s 41(1) of the Act requires shareholder approval where shares are being issued to directors or persons related to them who can be regarded as 'insiders'<sup>38</sup> in relation to the company. In such cases there is a real concern of a conflict of interests on the part of directors<sup>39</sup> because the share issue would be made to 'insiders.' Hence the requirement subjecting such share issues to approval by a special resolution of the shareholders empowers the shareholders to protect themselves against self-serving conduct on the part of the directors. It gives shareholders an oversight role to ensure that the share issues are above board.

Another shareholder protection measure employed by the new Act is the pre-emptive right provided for in s 39(2) and (3) which provide that:

'(2) If a private company proposes to issue any shares, other than as contemplated in subsection (1)(b), each shareholder of that private company has a right, before any other person who is not a shareholder of that company, to be offered and, within a reasonable time to subscribe for, a percentage of the shares to be issued equal to the voting power of that shareholder's general voting rights immediately before the offer was made.

(3) A private or personal liability company's Memorandum of Incorporation may limit, negate, restrict or place conditions upon the right set out in subsection (2), with respect to any or all classes of shares of that company.'

The utility of pre-emptive rights as a tool for protecting shareholders has been described thus:

"In the context of share issues, pre-emptive rights constitute a limitation on the power of directors to issue further shares. Pre-emptive rights limit their discretion regarding the persons from whom offers for subscription may be invited or to whom shares may be offered. By subscribing for further shares, existing shareholders who have the financial means to inject additional funds into the company can avoid a dilution of their shareholdings..."<sup>40</sup>

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<sup>37</sup> Section 41 of the new Act

<sup>38</sup> The term 'insider' in this instance is used loosely to refer to people that are in control of the company or, who work for the company, now or in the future, such as directors, future directors, prescribed officers, future prescribed officers or, persons related to them

<sup>39</sup> FHI Cassim, MF Cassim, R Cassim *et al* op cit note 36 at 223

<sup>40</sup> K Van der Linde, 'Pre-emptive rights in respect of share issues – misnomer or mistake?' (2008) 20 *SA Merc LJ* 510 at 511

The usefulness of a pre-emptive right depends on amongst other things, whether the company's shareholders can afford to inject additional funds into the company in consideration for the issues to be issued. Moreover, it should be noted that the pre-emptive right required by s 39(2) of the new Act only applies to private companies and personal liability companies.<sup>41</sup> Section 39 does not apply to public companies *except to the extent that the company's MOI provides otherwise*.<sup>42</sup> Accordingly the default position as provided for by the new Act is that shareholders in a public company generally do not enjoy pre-emptive rights unless the company's MOI provides for such rights. The implication of this for shareholders of public companies is that if they wish to protect their interest by means of pre-emptive rights they will have to be pro-active in reading the MOIs of companies that they invest in. If the MOIs of such companies do not provide for pre-emptive rights the shareholders will have to take positive steps to amend the company's MOI by including pre-emption rights. Failing this, shareholders in listed public companies would have to rely on the Johannesburg Stock Exchange [hereafter 'the JSE'] Listing Requirements as the primary tool for protecting their interests as discussed below.

The JSE Listing Requirements protect existing shareholders in listed companies against dilution of their equity in the context of new share issues by according them pre-emptive rights. A listed company that proposes to issue equity securities for cash is required to first offer those securities (unless the issue is an acquisition issue) effected by way of a rights offer to existing holders of equity securities in proportion to their existing holdings.<sup>43</sup> Further, a listed company may only offer equity securities for cash to persons other than the existing shareholders to the extent that such securities are not taken up by holders of equity in accordance with their pre-emption rights.<sup>44</sup>

An issue of equity securities for cash, made otherwise than to existing holders of securities in proportion to their existing holdings, is only permitted in terms of the JSE Listing Requirements if it is authorised by an ordinary resolution of the company's

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<sup>41</sup> Section 39(1)(b) of the new Act

<sup>42</sup> Section 39(1)(a) of the new Act

<sup>43</sup> Section 3 para 3.30 of the JSE Limited Listing Requirements (Service Issue 18) [hereafter 'the JSE Listing Requirements'], available at <https://www.jse.co.za/content/JSEEducationItems/JSEListingsRequirements.pdf>, accessed 20 December 2014

<sup>44</sup> Ibid. However, para 3.31 of Section 3 of the JSE Limited Listing Requirements provides that subject to the approval of the JSE, the application of the pre-emptive rights may be waived to the extent allowed by the Companies and Intellectual Property Commission established in terms of Section 185 of the new Companies Act

shareholders.<sup>45</sup> In other words the existing shareholders in a listed company could waive their pre-emptive rights by passing a general resolution authorising the company to issue shares to other persons. Thus the JSE Listing requirements protect shareholders through the use of the concept of pre-emptive rights and also the requirement for approval of new share issues by means of a resolution of the shareholders.

It appears odd that shareholders of publicly listed companies will now have to rely on the JSE Listing Requirements rather than the primary legislation governing companies to protect their interests. Moreover, unless the MOI of their company provides for pre-emptive rights, shareholders of unlisted public companies are left in the cold since they cannot rely on the JSE listing requirements for protection. In formulating the guidelines for the new Act the DTI considered including pre-emptive rights as either an optional or mandatory rule, but it is clear that in the end pre-emptive rights were considered as a vital protection against the dilution of shareholders' rights only in small companies with a limited number of shareholders. Hence, unless the MOI of the company provides otherwise, section 39 makes pre-emptive rights mandatory for private and personal liabilities companies and only optional for public companies.

However, it would seem that the risk of equity dilution is also a concern to shareholders in public companies and, shareholders in publicly listed companies rely on their veto power over share issues to protect themselves.<sup>46</sup> For instance it has been reported that the shareholders of Investec, a company listed on the JSE, voted against resolutions that would have given the company's directors authority to allot and issue additional shares; to allot shares for cash; and to issue additional preference shares.<sup>47</sup> One of the company's shareholders who reportedly voted against the resolutions is said to have commented that:

“Poor allocation of capital and dilution of shareholders persuaded us to vote against those resolutions even though we would normally support a limitation of 5 percent. Shareholders are signalling that they expect to be consulted on the issue of shares until the company has rebuilt trust in their ability to allocate capital in a productive manner.”<sup>48</sup>

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<sup>45</sup> JSE Listing Requirements section 3 para 3.32 read with section 5 paras 5.51(g) or 5.52(e) op cit note 43

<sup>46</sup> See A Crotty 'Investec shareholders lose confidence in management' *Business Report*, August 6 2012. Available at <http://www.iol.co.za/business/investec-shareholders-lose-confidence-in-management-1.1356613#.VJAHVCuUd1Y> , accessed 16 December 2014

<sup>47</sup> *ibid*

<sup>48</sup> *ibid*



In the light of the above as well as the fact that the JSE Listing requirements provide for pre-emptive rights it is surprising that the legislature saw fit to regulate pre-emptive rights only for private companies and personal liability companies.

While one could argue that s 39 provides public companies with the option to include pre-emptive rights in their MOI's, it must be emphasized that the usefulness of that option calls for greater vigilance on the part of shareholders. They must read and understand what their companies MOIs provide for. Besides, amending a company's MOI may not be that easy. An amendment to a company's MOI has to be passed by a special resolution of the shareholders which generally requires support of at least 75% of the votes exercised on the resolution.<sup>49</sup> Furthermore, in order to propose an amendment to a company's MOI the shareholder(s) making the proposal, must be able to exercise at least 10% of the voting rights that may be exercised on such a resolution.<sup>50</sup> Hence shareholders who wish to be protected by means of pre-emptive rights could find it difficult to amend a company's MOI in which case they, provided their company is listed, would have to rely on the JSE Listing Requirements as their primary tool to protect their interests.

It is submitted that in the interests of shareholder protection the new Act should have provided for pre-emptive rights as the statutory default position, not only for private companies, but also for public companies while allowing them to opt out of that statutory default position. This would also ensure that the new Act and the JSE Listing requirements were aligned. The provision of pre-emptive rights in public companies is nothing unusual; it is the default position in all European jurisdictions pursuant to article 33 of the Second European Union Company Law Directive as recast and published in the Official Journal of the European Union.<sup>51</sup> Institutional investors in the UK are fully behind the pre-emption rule and they have crafted Pre-emption Guidelines defining the limited circumstances in which they would waive their pre-emption rights by delegating the power to issue shares to the board.<sup>52</sup> This highlights the fact that pre-emption rights are valued by shareholders as a tool to protect their interests in the context of new share issues. It also echoes media reports that shareholders of publicly listed companies in South Africa routinely refuse to give directors

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<sup>49</sup> See section 16 (1)(c)(i) read with 65(9) of the new Act. In terms of s 65(10) a company's MOI may provide for a different percentage of voting rights to approve any special resolution.

<sup>50</sup> See section 16(1)(c)(i)(bb) of the new Act. In terms of s 16(2) a company's MOI may provide different requirements than those in the Act concerning proposals for amending the MOI.

<sup>51</sup> Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012. Available at <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32012L0030&from=EN>, accessed 5 January 2015. See also R Kraakman, J Armour and P Davies *et al* op cit note 14 at 195

<sup>52</sup> R Kraakman, J Armour and P Davies op cit note 14

the power to issue new shares.<sup>53</sup> This underlines the importance of pre-emption rights as a shareholder protection mechanism with regard to new share issues.

It appears that the South African legislature chose to follow the position in the USA where the default position in most state jurisdictions that have adopted the MBCA is that the shareholders of a corporation do not have a pre-emptive right to acquire the corporation's unissued shares except to the extent that the articles of incorporation so provide.<sup>54</sup> Arguably the legislature has chosen to follow this route in order to provide companies with flexibility in creating financing mechanisms in a fast changing global environment. Perhaps the argument is that requiring directors to approach the existing shareholders every time the company plans to issue new shares inhibits the company's ability to raise finance speedily and thus reduces its competitiveness in a globalised market characterised by rapid socio-economic and technological changes. However, as has already been shown above, it would appear that shareholders would much rather prefer having a say on new share issues and the protection offered by pre-emptive rights, than to give directors a general power to issue shares.<sup>55</sup>

It is to be noted that the new Act imposes fiduciary duties on company directors,<sup>56</sup> which duties could be relied on as a remedy against abuse of the directors' power to issue shares. However it must be noted that these duties are enforced through litigation after harm has already been done to the company. It is submitted that prevention is better than cure, especially if that cure entails resorting to litigation in a country like ours where access to the courts may not be easy or cheap for some.

### **3.3.4 Application of s 15(2)(a)(iii)**

It is pertinent to point out that s 38(1) of the new Act is an unalterable provision as defined in s 1 of the new Act. This means that s 38(1) is a provision that does not expressly contemplate that its effect on a particular company may be negated, restricted, limited, qualified, extended or otherwise altered in substance or effect by a company's MOI or rules.<sup>57</sup> Thus at first sight it would appear that the company would not, by a provision in its MOI, be able to curtail the board's power to issue shares by making the exercise of that power subject to approval by shareholders. That said it is arguable that although s 38(1) is an unalterable provision,

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<sup>53</sup> A Crotty op cit note 46

<sup>54</sup> Section 6.30 (a) of the Model Business Corporations Act

<sup>55</sup> A Crotty op cit note 46

<sup>56</sup> Sections 75 and 76 of the new Act. See the discussion in chapter 4 on directors' duties.

<sup>57</sup> Section 1 of the new Act

shareholders are not without means to protect themselves against an unfettered exercise of the directors' power to issue shares. For s 15(2)(a)(iii) of the new Act provides that,

*'The Memorandum of Incorporation of any company may include any provision imposing on the company a higher standard, greater restriction, longer period of time or any similarly more onerous requirement, than would otherwise apply to the company in terms of an unalterable provision of this Act,'* (writer's own emphasis).

In the light of s 15(2)(a)(iii) it may be argued that shareholders are in a position to control the directors' power to issue shares. They could control it by subjecting the exercise of that power to an onerous requirement namely that it should be approved by shareholders in general meeting. Indeed it has been said that shareholders can effectively prevent the board from issuing shares at any time by amending the company's MOI in accordance with s 15(2)(a)(iii) to provide that any issue of shares also requires the approval of shareholders.<sup>58</sup> If this argument is correct, then the implication for shareholders of the changes made by the new Act with regard to issuing of shares is that shareholders will need to be pro-active in protecting their interests by amending a company's MOI in terms of s 15(2)(a)(iii) to ensure that the board's new-found power is subjected to shareholder approval.

While the above interpretation of s 15(2)(a)(iii) would put shareholders in a position to protect their interests, an interesting counter argument that could potentially be raised against this interpretation is as follows: The language used in s 15(2)(a)(iii) contemplates that the section is only applicable to those unalterable provisions which impose a requirement, restriction or standard that has to be adhered to before a power could be exercised. This is because the words used in that section are comparative adjectives. Therefore, s 15(2)(a)(iii) contemplates that the provision that may be included in a MOI to change the effect of an unalterable provision must impose on the company, a *higher* standard, *greater* restriction, *longer* period of time, or any similarly *more* onerous requirement than would otherwise apply to the company in terms of an unalterable provision of the Act. The use of the comparative adjectives in the sections pre-supposes the existence of some standard, restriction or requirement which may be enhanced by making it higher, greater or more onerous as the case may be. For the comparative form of an adjective is used for comparing two people or things.<sup>59</sup>

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<sup>58</sup>See C Stein & G Everingham op cit note 2 at 72

<sup>59</sup> Online Oxford Dictionary available at <http://oxforddictionaries.com/us/words/comparative-and-superlative-adjectives-american>, accessed 9 February 2013

The argument then would be that a provision may be included in the MOI in terms of s 15(2)(a)(iii) *only if* the unalterable provision in the Act which the provision in the MOI seeks to change *already* contains a standard, restriction, time period or requirement which the provision in the MOI seeks to increase.

Put in other words the argument would be that it is not permissible to insert a provision in the MOI in terms of s 15(2)(a)(iii) purporting to change the effect of an unalterable provision by imposing a standard, restriction, time period or other requirement where the unalterable provision itself does not impose any such standard, restriction, time period or other requirement in the first place. To do otherwise, so the argument would go, would render the comparative adjectives used in s 15(2)(a)(iii) superfluous because there is no existing standard, restriction or requirement to be enhanced by making it greater, higher or more onerous.

As part of the above argument it would be conceded that s 38(1) imposes a restriction – as opposed to a requirement or standard – to the extent that it prescribes that the directors may issue shares, ‘*only within the classes, and to the extent, that the shares have been authorized by or in terms of the company’s Memorandum of Incorporation....*’ However, so it will be argued, this restriction relates to the class and extent, that is the number, of shares. Therefore, the only, if any, permissible provision that could be included in the MOI in terms of s 15(2)(a)(iii) would be one that imposes a *greater* restriction on the classes and number of shares in respect of which the directors may exercise their power in terms s 38(1).

Although the above argument may be compelling, its weakness is that it is based on an unduly restrictive interpretation of s 15(2)(a)(iii) of the new Act. Such a restrictive interpretation disempowers shareholders by diminishing their ability to protect themselves against the unfettered exercise of the directors’ power to issue shares. There is nothing in the language of s 15(2)(a)(iii) of the new Act to justify limiting the application of that section only to unalterable provisions that already contain a standard, restriction, time period or other requirement. It does not necessarily follow that because s 15(2)(a)(iii) uses comparative adjectives, therefore the unalterable provision in the Act which the provision in the MOI seeks to change *must already* contain a standard, restriction, time period or requirement. It is difficult to see why and how the comparative adjectives used in s 15(2)(a)(iii) would become superfluous where one is dealing with an unalterable provision that does not already contain a standard, restriction, time period or requirement.

For, supposing that the unalterable provision in question contains no requirements, restrictions, standards or whatever the case may be, would the imposition of a new, in place of the non-existent standard, restriction or, requirement not amount to imposing a *higher* standard, *greater* restriction or *more* onerous requirement than would otherwise apply to the company in terms of the unalterable provision? Surely it cannot be argued that where previously no standard, restriction or requirement existed, the imposition of a new standard, restriction or requirement in that instance does not amount to imposing a *greater* standard, *higher* restriction or *more* onerous requirement than previously existed. Accordingly, there is no basis for limiting the application of s 15(2)(a)(iii) only to an unalterable provision that already contains a standard, requirement, time period or restriction.

The modern trend in statutory interpretation is to interpret legislative provisions purposively having regard to the context of the provision in question.<sup>60</sup> In this regard context refers to *inter alia*, 'the matter of the statute, its apparent scope and purpose, and within limits, its background.'<sup>61</sup> Section s 5(1) also provides that the new Act 'must be interpreted and applied in a manner that gives effect to the purposes set out in s 7 of that Act.' The purposes of the new Act include, amongst other things, promoting the development of the South African economy by creating flexibility and simplicity in the formation and maintenance of companies, balancing the rights and obligations of shareholders and directors within companies.<sup>62</sup> It is to be hoped that the courts will adopt a wide interpretation of s 15(2)(a)(iii) that allows a provision in the MOI to change the effect of an unalterable provision by imposing a standard, restriction, time period or other requirement even where the unalterable provision in question does not already contain any such standard, restriction, time period or other requirement. Such a wide interpretation would empower shareholders to protect their interests by enabling them to override or veto the wide power given to directors regarding the issuing of shares.<sup>63</sup> Such a wide interpretation would be in keeping with the purposes of the new Act in that it will promote flexibility in the management of companies.

Given the potential that s 15(2)(a)(iii) could be interpreted restrictively to the detriment of shareholders as discussed above, it is suggested that the legislature should amend the section to make it clear that companies can amend an unalterable provision in

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<sup>60</sup> *Bato Star Fishing (Pty) Ltd v Minister of Environmental Affairs and Tourism and Others* 2004 (4) SA 490 (CC) para 90

<sup>61</sup> *Jaga v Dönges NO and Another; Bhana v Dönges NO and Another* 1950 (4) SA 653 (A) at 662

<sup>62</sup> Section 7(b)(ii) & (iii) of the new Act

<sup>63</sup> See C Stein & G Everingham op cit note 2 at 72

terms even where the unalterable provision does not prescribe any standard, restriction, time period or other requirement.

### **3.4.0 Distributions**

#### **3.4.1 Distributions - General**

The distribution of a company's assets to any of its shareholders is another important area of corporate finance in which the new Act has brought about changes that raise concerns for corporate governance and the protection of shareholders' interests. Generally, the distribution of its assets by a company to its shareholders may take place as a return on share capital or as a return of share capital.<sup>64</sup> Whatever form it takes, a distribution of a company's assets to its shareholders carries with it the risk of abuses such as the discriminatory and unequal treatment of shareholders.<sup>65</sup> In view of these risks corporate law must strive to regulate distributions so as to protect the interests of, amongst others, minority shareholders of the company.<sup>66</sup> In the context of the changes made by the new Act concerning the regulation of distributions, the concern is whether the new Act has shifted the balance of power between shareholders and directors in favour of the latter. And, if so, what implications does this have for corporate governance in South Africa and, in particular, the protection of shareholders' interests.

The discussion that follows below highlights some of the changes made by the new Act with regard to the regulation of different types of distributions. The discussion will cover the problems associated with the different types of distributions so as to give context for understanding the nature of the changes made by the new Act, as well as the implications of those changes for corporate governance and the protection of shareholders' interests. It will also be shown that in certain instances, the changes made by the new Act have the effect of giving directors freedom with regard to distributions and that this is achieved by taking away certain powers enjoyed by shareholders under the old Act.

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<sup>64</sup> K Van der Linde 'The regulation of distributions to shareholders in the Companies Act 2008' (2009) *TSAR* 484

<sup>65</sup> R Dugan 'Repurchase of own shares for New Zealand' (1987) *Victoria University of Wellington Law Review* 179 at 180

<sup>66</sup> R Jooste 'Issues relating to the regulation of distributions by the 2008 Companies Act' (2009) *SALJ* 627

To clarify the approach taken in dealing with distributions in this thesis it is relevant to briefly note the marked difference in approaches to the regulation of distributions between the new Act and the old Act.

The old Act did not define the term, ‘distribution.’<sup>67</sup> It dealt with different types of distributions separately. For instance, diverse provisions of the old Act dealt with certain distributions as follows:

- Payments of interest on share capital<sup>68</sup>
- Payments made by a company to its shareholders as a consideration for the repurchase of its own shares<sup>69</sup>
- Payments in general to shareholders made on account of their shareholding in the company<sup>70</sup>
- Payments made by a company to its shareholders upon redemption of redeemable preference shares<sup>71</sup>

On the other hand, section 1 of the new Act comprehensively defines as distribution as follows:

“distribution” means a direct or indirect-

(a) transfer by a company of money or other property of the company, other than its own shares, to or for the benefit of one or more holders of any of the shares, or to the holder of a beneficial interest in any such shares, of that company or of another company within the same group of companies, whether-

(i) in the form of a dividend;

(ii) as a payment in lieu of a capitalisation share, as contemplated in section 47;

(iii) as consideration for the acquisition-

(aa) by the company of any of its shares, as contemplated in section 48; or

(bb) by any company within the same group of companies, of any shares of a company within that group of companies; or

(iv) otherwise in respect of any of the shares of that company or of another company within the same group of companies, subject to section 164(19);

(b) incurrence of a debt or other obligation by a company for the benefit of one or more holders of any of the shares of that company or of another company within the same group of companies; or

(c) forgiveness or waiver by a company of a debt or other obligation owed to the company by one or more holders of any of the shares of that company or of another company within the same group of companies,

but does not include any such action taken upon the final liquidation of the company.

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<sup>67</sup> K Van der Linde ‘The regulations of distributions to shareholders’ op cit note 64

<sup>68</sup> Section 79 of the old Act

<sup>69</sup> Section 85 of the old Act

<sup>70</sup> Section 90 of the old Act

<sup>71</sup> Section 98 of the old Act

The definition can be divided into three broad classes of distributions. The first class is a direct or indirect transfer by a company of money or other property of the company.<sup>72</sup> The second class involves the incurrence of a debt or other obligation by a company for the benefit of one or more holders of any of the shares of that company or of another company within the same group of companies.<sup>73</sup> The third class of distributions is the forgiveness or waiver by a company of a debt or other obligation owed to the company by one or more holders of any of the shares of that company or of another company within the same group of companies.<sup>74</sup> The definition of a distribution in the new Act bears some resemblance to the definition in the MBCA where a distribution is defined as follows:<sup>75</sup>

“Distribution” means a direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; or otherwise.

It is interesting to note that the definition of the term ‘distribution’ in s 1.40(6) of the MBCA does not expressly cover the forgiveness or waiver of a debt.<sup>76</sup> The words ‘or otherwise,’ at the end of the definition in s 1.40(6) appear to indicate that the list of examples of distributions appearing before those words is not exhaustive. Moreover all the examples preceding those words are limited to the class of distributions involving a direct or indirect transfer of money or other property of the company. Hence it is doubtful whether the words ‘or otherwise’ are a catch-all phrase that would include forgiveness or waiver of a debt. Thus it is arguable that the definition of a distribution in our Act is wider than the definition in the MBCA and hence it better protects the company and ultimately the shareholders against instances where the company’s wealth could be transferred to a shareholder by means of the forgiveness or waiver of a debt.

It is important to note that, unlike the old Act, the new Act does not regulate the different types of distributions separately, but it has a global provision namely, s 46, which regulates distributions in general.<sup>77</sup>

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<sup>72</sup> Section 1 (a) under ‘distribution’

<sup>73</sup> Section 1(b) under ‘distribution’

<sup>74</sup> Section 1(c) under ‘distribution’

<sup>75</sup> Section 1.40(6) of the MBCA

<sup>76</sup> K Van der Linde ‘The regulation of distributions to shareholders’ op cit note 64

<sup>77</sup> R Jooste op cit note 66



Since this thesis is not majoring on distributions *per se*, it is not intended to discuss in detail each example of the different types of distributions as defined in the Act. Only those aspects of the three broad classes of distributions noted above which impact on the balance of power between shareholders and directors and also on the protection of shareholders will be discussed. Given the different approaches in the new and the old Act it is appropriate to clarify the approach taken in dealing with distributions in this thesis. For reasons that follow below, this thesis proposes to deal separately with the different kinds of distributions. Certain types of distributions, such as the payment by a company of a consideration for the acquisition of its own shares and a dividend payment, resemble each other in that they share the same characteristic namely; they both involve a transfer of money by a company to its shareholders. Consequently, it may appear logical to lump them together under the banner of distribution without making a distinction between them. However, they are very different from each other.<sup>78</sup> Moreover, they raise different corporate governance issues when it comes to the protection of shareholders. For instance, payment in respect of a share repurchase is made to the shareholder who sells his/her shares to the company; on the other hand, a dividend payment is made to shareholders of a particular class of shares. Accordingly, with a dividend payment there cannot be disparate treatment of shareholders within the same class whereas with a share repurchase it is possible that shareholders of the same class could be treated disproportionately.<sup>79</sup>

Therefore, the approach taken in this thesis is to deal separately with specific types of distributions in order to highlight with greater clarity the nature of the changes made by the new Act with regard to the regulation of those types of distributions. It is also submitted that such an approach makes it possible to discuss more lucidly the specific issues arising in relation to a particular type of distribution.

### **3.4.2 Share repurchases**

#### **3.4.2.1 Problems associated with share repurchases**

The payment made to shareholders by a company when it repurchases its own shares is a distribution as defined in the Act.<sup>80</sup> And there is good reason why the repurchase of its own shares by a company should be regulated. It has been said that a share repurchase operates at

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<sup>78</sup> FHI Cassim 'The reform of company law and the capital maintenance concept' (2005) 122 *SALJ* 283 at 287

<sup>79</sup> *Ibid*

<sup>80</sup> Para (a)(iii) of the definition in Section 1

once as a distribution of assets, a reorganisation of ownership and a transfer of shares.<sup>81</sup> In each of these three functions a share repurchase raises significant corporate governance issues because it is susceptible to misuse in a number of different ways.<sup>82</sup> In its function as a share transfer, a share repurchase brings with it the possibility of insider trading and price manipulation.<sup>83</sup> In its function as a distribution of assets, a share repurchase is associated with the risk of asset stripping and debt avoidance. Finally, as a reorganisation share repurchase brings the possibility of unfair and discriminatory treatment of minority shareholders.<sup>84</sup> In the context of corporate governance in South Africa, the unfair and discriminatory treatment of shareholders runs contrary to the tenets of good corporate governance practices which demand that shareholders be treated equally.<sup>85</sup> In the light of this it is crucial that corporate law regulates share repurchases in a way that accords with good corporate governance practices by protecting shareholders' interests. The discussion that follows below will highlight how the old Act sought to protect shareholders' interests in the context of share repurchases and how changes made by the new Act appear to take away that protection in pursuit of flexibility.

### **3.4.2.2 Share repurchases in terms of the old Companies Act 61 of 1973**

For a greater part of its existence the old Act sought to prevent the abuses associated with different types of distributions by means of the capital maintenance rule.<sup>86</sup> The capital maintenance rule had its genesis in the case of *Trevor v Whitworth*.<sup>87</sup> Essentially the rule prohibited a company from returning its capital funds to its members unless this was done pursuant to a formal reduction of its share capital.<sup>88</sup> The rule gave rise to several principles one of which prohibited a company from acquiring its own shares or shares in its holding company.<sup>89</sup> The capital maintenance rule was said to protect a company's creditors.<sup>90</sup> However, the rule did not only protect the company's creditors, it was thought to protect the

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<sup>81</sup> R Dugan op cit note 65

<sup>82</sup> *ibid*

<sup>83</sup> *ibid*

<sup>84</sup> *ibid*

<sup>85</sup> Institute of Directors in South Africa, *Executive Summary King Report on Corporate Governance for South Africa -2002* page 11 para 18.6, available at [http://www.ecgi.org/codes/documents/executive\\_summary.pdf](http://www.ecgi.org/codes/documents/executive_summary.pdf) , accessed on 20 March 2015

<sup>86</sup> R Jooste op cit note 66

<sup>87</sup> *Trevor v Whitworth* [1886-90] All ER rep 46 (HL)

<sup>88</sup> MS Blackman, RD Jooste and GK Everingham *et al* op cit note 22

<sup>89</sup> R Jooste op cit note 66

<sup>90</sup> F Kubler 'The rules of capital under pressure of the securities markets,' in KJ. Hopt & E Wymeersch (eds) *Capital Markets and Company Law* (2003) at 95

interests of shareholders as well.<sup>91</sup> For instance, it has been argued that the general prohibition against the acquisition of its own shares by a company prevents the majority from absorbing liquid assets to the detriment of minority shareholders.<sup>92</sup>

The role of the capital maintenance rule as a protective measure for creditors and minority shareholders effectively ended when the old Act was amended in 1999.<sup>93</sup> A significant consequence of that amendment was that the capital maintenance rule was essentially abolished.<sup>94</sup> The abolishment of the capital maintenance rule saw the establishment of the 'solvency and liquidity tests' in South African corporate law.<sup>95</sup> Hence from 1999 onwards the old Act protected creditors and minority shareholders where companies acquired their own shares by way of certain requirements including the solvency and liquidity tests.<sup>96</sup>

Part of the measures in the old Act designed to protect shareholders in the context of share repurchases included the two requirements for a share repurchase contained in s 85(1) of that Act. In terms of that section a company could repurchase its own shares if it was authorized to do so by its articles and, the repurchase was approved by way of a special resolution of the company's shareholders. That these requirements served to protect shareholders is supported by the following comment relating to the power to repurchase; 'The power in question undeniably has great potential for altering the nature of the company and therefore the shareholders as a body should be required to consider whether they want it to be available to the company.'<sup>97</sup>

With regard to the requirement that the share repurchase had to be approved by a special resolution, it must be noted that the special resolution envisaged by s 85(1) could take the form of a general approval or a specific approval for a particular acquisition.<sup>98</sup> If the approval was a general one, such an approval was valid only until the next annual general meeting of the company and, it could be varied or revoked by a special resolution passed any time prior to the next annual general meeting.<sup>99</sup> It is submitted that the requirement in s 85(1)

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<sup>91</sup> *ibid*

<sup>92</sup> *ibid*

<sup>93</sup> See the Companies Act Amendment Act 37 of 1999

<sup>94</sup> FHI Cassim 'The reform of company law and the capital maintenance concept' *op cit* note 78 at 284. See also K Van der Linde 'Capital maintenance is dead – long live solvency and liquidity' (1999) 7 *Juta's Bus. L.* 155

<sup>95</sup> FHI Cassim *ibid*

<sup>96</sup> R Jooste *op cit* note 67

<sup>97</sup> E Magner 'The power of a company to purchase its own shares: a comparative approach' (1984) 2 *Company and Securities Law Journal* 79 at 85

<sup>98</sup> Section 85(2) of the old Act

<sup>99</sup> Section 85(3) of the old Act

of the old Act that the repurchase had to be approved by a special resolution of the company's shareholders also served to empower shareholders. It secured their participation in the decision making process of such an important transaction which has the potential to alter the balance of power within the company. Therefore, the old Act empowered shareholders to protect their interests by giving them a power to veto the exercise of the repurchase power.

In addition to the above requirements, the old Act also laid down certain procedural requirements with regard to share repurchases whose import was to protect shareholders.<sup>100</sup> The old Act provided for two types of procedures that had to be followed depending on whether the company was repurchasing its own shares on the open market, or if the company was repurchasing its own shares by way of an off-market transaction.<sup>101</sup> The most relevant procedure for the purposes of this discussion is the one relating to off market transactions as such transactions represent a corporate governance challenge because of the attendant risk of unequal treatment of shareholders. The applicable provision in the old Act pertaining to off-market transactions was s 87(1). That section required the company to send a written offering circular to each registered shareholder offering to acquire shares from the shareholder; the circular also had to state the number and the class or kind of its issued shares which the company proposed to acquire, and to specify the terms and reasons for the offer. Where, in response to the offer circular, the shareholders proposed to sell a greater number of shares than the company offered to repurchase, the company was required to repurchase on a pro rata basis from all shareholders who offered to sell their shares.<sup>102</sup>

The relevance of the procedural requirement contained in section 87(1) of the old Act is best captured by Cassim who explains that:

‘The procedure for a share buy-back, as laid down in s 87, is of fundamental importance in preventing the abuse of the share repurchase power and discrimination against shareholders holding the same class of shares. The procedure is designed to protect the interests of shareholders. It ensures that shareholders of the same class are offered the same opportunity as every other shareholder. Equality of treatment lies at the basis of s 87(1).’<sup>103</sup>

The procedural requirement served to prevent ‘abuse arising from certain shareholders selling their shares back to the company at a time when the company is facing a severe financial

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<sup>100</sup> See section 87 of the old Act

<sup>101</sup> Kathleen van der Linde ‘A company’s purchase of its own shares’ (1999) 7 *Juta’s Bus.L.* 68 at 69-70

<sup>102</sup> Section 87(4) of the old Act

<sup>103</sup> Cassim FHI ‘The reform of company law and the capital maintenance concept’ op cit note 78

crisis thereby leaving the less favoured shareholders to face the crisis.’<sup>104</sup> Requiring share repurchases to be made on a pro rata basis ensured that all shareholders of the affected class had an opportunity to sell their shares back to the company on the same terms.<sup>105</sup>

In the light of the above it is clear that the old Act protected shareholders or empowered shareholders to protect their interests through the requirements it laid down in respect of share repurchases. As discussed below, some of these requirements – or protective measures – have been discarded by the new Act, presumably in pursuit of giving directors flexibility in effecting share repurchases. This raises concerns whether the changes made by the new Act have elevated flexibility at the expense of the protection of shareholders.

### ***3.4.2.3 Share repurchases in terms of the new Companies Act 71 of 2008***

The starting point is to note that the definition of a ‘distribution’ in the new Act – discussed earlier, includes the payment by a company of a consideration for the repurchase of its own shares by the company.<sup>106</sup> Therefore, the provisions in the new Act relating to distributions in the new Act are applicable to share repurchases. In this regard the most relevant provisions are ss 46 and 48.

Section 46 of the new Act prescribes the requirements to be complied with concerning the making of a distribution by a company. Generally the new Act provides that the company cannot make a distribution unless the distribution is pursuant to an existing legal obligation of the company, or a court order or, unless the distribution has been authorized by a resolution of the board of the company.<sup>107</sup> Further, a company must not make a distribution unless it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution and the board of the company, by resolution, has acknowledged that it has applied the solvency and liquidity test and reasonably concluded that the company will meet the test immediately after the distribution is made.<sup>108</sup> In addition to these provisions relating to distributions in general, the other provision relevant to share repurchases is s 48(2)(a) which specifically deals with repurchases. In essence that section empowers the board of the company to decide that the company will acquire its own shares provided that such a decision satisfies the requirements of s 46 relating to distributions as

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<sup>104</sup> Cassim FHI ‘The new statutory provisions on company share repurchases: a critical analysis’ (1999) 116 *SALJ* 760 at 772

<sup>105</sup> *ibid*

<sup>106</sup> Para (a)(iii)(aa) of the definition in section 1 of the new Act

<sup>107</sup> S 46(1)(a)(i) & (ii) of the new Act

<sup>108</sup> S46(1)(b) & (c) of the new Act

well as other requirements laid down in the rest of s 48. Section 48(2)(a) is an unalterable provision therefore any attempts to limit or, qualify the board's power to authorize share repurchases via provisions in the MOI must comply with the prescripts of s 15(2)(a)(iii). In this regard the observations made in paragraph 3.3.4 above concerning the limited scope, under s 15(2)(a)(iii), for limiting or, qualifying the power of directors to issue shares in terms of s 38(1) apply *mutatis mutandis* in relation to the directors' power to authorize share repurchases in terms of s 48(2)(a).

It is noteworthy that s 48 generally does not require shareholder approval for a share repurchase. This stands in contra-distinction to the position under the old Act where the general position was that shareholder approval was required in relation to a share repurchase.<sup>109</sup> The new Act gives power to the board of directors to decide on a share repurchase. Accordingly, it appears that the new Act has shifted the balance of power in this regard. At the time the Act was passed the decision to exclude shareholders from the decision making process was questioned in the light of the fact that shareholders' interests were at risk where share repurchases are concerned.<sup>110</sup>

In addition to the above, it should also be noted that the new Act does not have the equivalent of the procedural requirement in s 87(1) of the old Act whereby a company making an off-market share repurchase was required to send a written offer circular wherein the company informed each registered shareholder of the share repurchase and also offered to acquire their shares. As previously observed, such a requirement in the old Act prevented the incidence of unequal treatment of shareholders by ensuring that each shareholder was given the same opportunity to sell their shares to the company. Therefore, the absence of a similar requirement in s 48 of the new Act appears to deal a blow to the protection of minority shareholders in the context of off-market share repurchases.<sup>111</sup> In this regard the new Act has been criticized thus;

‘Not only does the new Act exclude shareholders from deciding on a buy-back, it also contains no provisions aimed at informing shareholders as to the merits or demerits of an offer to acquire their shares. No circulars in a prescribed form, like those required by the current Act (see s 87 of the current Act [the old Companies Act 61 of 1973]), have to be sent to all shareholders when an offer for their shares is made (in the case of listed shares the Listing Rules of the JSE Securities Exchange

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<sup>109</sup> Section 85(1) of the old Act

<sup>110</sup> See for example K Van der Linde ‘*Aspects of the regulation of share capital and distributions to shareholders*’ (unpublished LLD thesis, UNISA, 2008) page 494-495; see also R Jooste op cit note 74 at 637-638

<sup>111</sup> C Stein and G Everingham op cit 2 note at 190

SA would of course be applicable). No distinction is drawn in the new Act between general and selective offers (unlike s 87 of the current Act). No special safeguards have been enacted, aimed at the potential mischief inherent in selective offers.<sup>112</sup>

Therefore in the context of share repurchases it appears that the new Act has shifted the balance of power between shareholders and directors in favour of the latter. The new Act has dispensed with important protective measures that existed in terms of the provisions of the old Act. That said it must be noted that the new Act does give some room, albeit limited, for shareholders to participate in the decision making process concerning share repurchases. In terms of s 48(8)(a) a repurchase decision by the board of a company must be approved by a special resolution of the shareholders of the company if any shares are to be acquired by the company from a director or prescribed officer of the company, or a person related to a director or a prescribed officer.

The position in terms of the new Act regarding share repurchases is similar to the position under the MBCA. The acquisition of its own shares by a company is regulated by 6.31(a) of the MBCA which provides that ‘a corporation may acquire its own shares, and shares so acquired constitute authorized but unissued shares.’ In terms of the MBCA it would seem that the power to authorise a repurchase is exclusively invested in the board by virtue of the fact that s 6.40 (a) vests the power to authorise a distribution in the board, and s 1.40(6) defines a distribution to include a purchase, redemption, or other acquisition of the corporation’s shares. In Delaware s 160(a) of the Delaware General Corporations Law authorises a corporation to repurchase its shares but it does not expressly empower the board to authorise share repurchases. However, it would also seem that in Delaware the board would have authority to authorise a repurchase of its own shares by the company based on the fact that s 140(a) of the Delaware General Corporations Law provides for the business and affairs of every corporation to be managed by or under the control of the board. Moreover, s 174 imposes personal liability on the directors under whose watch an unlawful stock purchase takes place in violation of s 160.

However to the extent that s 48(8)(a) of the new Act requires approval by a special resolution of the shareholders where shares are to be repurchased from a director or prescribed officer of the company, the South African position differs from the Delaware position and the position in the MBCA. In this respect the new Act better protects

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<sup>112</sup> R Jooste op cit note 66 at 638

shareholders against share repurchases tainted by the directors' self-interest than the Delaware General Corporations Law. The protection of shareholders in the context of selective share repurchases could have been enhanced in the new Act by following the example of Australia where s 257D of the Australian Corporations Act requires that a selective share repurchase be approved by a special resolution of the shareholders in general meeting and the notice of the meeting must include a statement setting out all material information that is relevant to the proposal regarding the selective share repurchase.

Section 61(1)(b)(i) and (ii) of the New Zealand Companies Act, 1993 also protects shareholders in the case of selective repurchases by prescribing that all shareholders must consent in writing to a selective offer or, the selective offer must be expressly permitted by the company's constitution and it must be made in accordance with the procedure set out in s 61 of that Act. Section s 61(1) prescribes *inter alia*, that the board may make a selective offer to repurchase shares only if it has previously resolved that the acquisition is of benefit to the remaining shareholders and, that the terms of the offer and the consideration offered for the shares are fair and reasonable to the remaining shareholders. Further, s 61(5) requires the company to send a disclosure document to every shareholder before any offer to repurchase shares is made. In terms of s 62 of the New Zealand Companies Act the disclosure document must provide the following information,

- '(a) the nature and terms of the offer, and if made to specified shareholders, to whom it will be made; and
- (b) the nature and extent of any relevant interest of any director of the company in any shares the subject of the offer; and
- (c) the text of the resolution required by section 61, together with such further information and explanation as may be necessary to enable a reasonable shareholder to understand the nature and implications for the company and its shareholders of the proposed acquisition.'

Hence the requirement for a disclosure document facilitates transparency and thereby empowers shareholders to make informed decisions and to protect their interests in the context of selective repurchases.

### **3.4.3 Dividend Payments**

#### **3.4.3.1 Authority to make dividend payments**

A dividend payment is listed in the Act as an example of a distribution which falls in the category of 'a direct or indirect transfer, by a company of money or other property of the



company, other than its own shares, to or for the benefit of one or more holders of any of the shares of that company or of another company within the same group of companies.’<sup>113</sup> Hence the requirements for a distribution prescribed by s 46 noted above with regard to the payment of a consideration for the acquisition of its own shares by a company also apply to a dividend payment. This contrasts with the approach under the old Act where, as noted earlier, dividend payments and payments in respect of share repurchases were governed by different provisions.<sup>114</sup>

Under the old Act dividend payments were governed by s 90 which provided that:

- (1) A company may make payments to its shareholders subject to the provisions of this section and if authorized thereto by its articles.
- (2) A company shall not make any payment in whatever form to its shareholders if there are reasonable grounds for believing that-
  - (a) the company is, or would after the payment be, unable to pay its debts as they become due in the ordinary course of business; or
  - (b) the consolidated assets of the company fairly valued would after the payment be less than the consolidated liabilities of the company.
- (3) For the purposes of this section 'payment' includes any direct or indirect payment or transfer of money or other property to a shareholder of the company by virtue of the shareholder's shareholding in the company, but excludes an acquisition of shares in terms of section 85, a redemption of redeemable preference shares in terms of section 98, any acquisition of shares in terms of an order of Court and the issue of capitalisation shares in the company.
- (4) A shareholder shall be liable to the company for any payment received contrary to the provisions of subsection (2).

Therefore a company could only make a payment (or a dividend) if it was authorized to do so by its articles [henceforth a reference to ‘payments’ would also include a reference to a dividend payment]. Since a company’s power to make a payment was determined by the articles this meant it was possible for the articles to impose any restrictions or requirements on the company’s ability to make payments. Hence the articles could restrict the funds that could be utilized to make a particular payment by providing, for example that, a dividend payment shall only be made out of profits.<sup>115</sup> By contrast s 46 of the new Act does not require any authorization in the MOI. It appears that a company now has inherent power to make a payment even in the absence of a provision expressly authorising such payments in the MOI.

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<sup>113</sup> S 1 “distribution” para (a)(i)

<sup>114</sup> See the discussion in para 3.4.1 above

<sup>115</sup> MS Blackman, RD Jooste and GK Everingham *Commentary on the Companies Act* (2002) Volume 1 [Revision Service 6] (2009) at 5 – 118

Section 46 is an unalterable provision hence it is debatable whether the MOI could impose any prohibitions, conditions or requirements regarding distributions. Van der Linde is of the view that the MOI could validly impose a requirement that any distribution by the company must be approved by the shareholders.<sup>116</sup> Although the basis of Van der Linde's view is not apparent from her paper this writer agrees with her view on the basis that, as discussed in paragraph 3.3.4 above, s 15(2)(a)(iii) permits the MOI to include a provision imposing on the company a higher standard, greater restriction or more onerous requirement than would otherwise apply to the company in terms of an unalterable provision of this Act.<sup>117</sup> In line with this it is arguable that s 15(2)(a)(iii) would also permit a provision in the MOI restricting the company from paying dividends otherwise than out of profits as this would be a higher standard, greater restriction or more onerous requirement than would otherwise apply in terms of s 46.

Admittedly the validity of a clause in a MOI which seeks to impose any prohibitions, conditions or requirements regarding distributions is not always certain since it is dependent on a value judgment based on s 15(2)(a)(iii), that is whether it actually imposes a higher standard, greater restriction or more onerous requirement than would otherwise be applicable in terms of the unalterable provision. This uncertainty is undesirable. In the context of s 46 perhaps it would have been desirable if the legislature had followed the example of s 6.40 of the MBCA which provides inter alia that 'A board of directors may authorize and the corporation may make distributions to its shareholders subject to restriction by the articles of incorporation...' This provision is clear and simple; the board has power to authorise distributions subject to any restriction in the articles. And, the validity of the restriction in the articles is not dependent on whether it imposes a higher standard, greater restriction or more onerous requirement.

#### **3.4.3.2 Who has the power to authorize and make dividend payments?**

Section 90 did not specify which organ had the power to authorize and make payments. However the model articles for both public and private companies provided that, 'the company in annual general meeting may declare dividends but no dividend shall exceed the

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<sup>116</sup> K Van der Linde 'The Regulation of Distributions to Shareholders, op cit note 64 at 492

<sup>117</sup> See P Delpont, Q Vorster, D Burdette *et al* Henochsberg *on the Companies Act, 71 of 2008* (2011) 197.

amount recommended by directors.’<sup>118</sup> The model articles also authorized ‘directors from time to time to pay to the members such interim dividends as appear to the directors to be justified by the profits of the company.’<sup>119</sup> If a company’s articles were silent regarding the payment of dividends the common law applied. At common law dividends are payable only when declared by an ordinary resolution of the shareholders in general meeting.<sup>120</sup> It would seem the actual payment had to be made by or on the authority of the directors.<sup>121</sup> In this respect it is pertinent to note that the model articles provided that ‘every dividend or other moneys payable in cash in respect of shares may be paid by cheque, warrant, coupons or otherwise as the directors may from time to time determine.’<sup>122</sup> Moreover generally the articles conferred power on the board to exercise all such powers of the company that were not required by the Act or the articles to be exercised by the company in general meeting.<sup>123</sup>

By directly empowering the board to authorize distributions (including dividend payments) s 46 of the new Act has significantly changed the position regarding who has the power to authorize dividend payments. In this respect s 46 has set South African company law apart from the law of the UK where the matter of who has power to authorize dividend payments is still determined by a company’s articles.<sup>124</sup> As was the case under the old Act, the UK model articles for both private and public companies limited by shares determine that a dividend which does not exceed the amount recommended by the directors may be declared by ordinary resolution.<sup>125</sup> Thus in the UK the position remains as per common law that if the articles are silent on the matter, the power to decide on dividend payments would rest with the shareholders in general meeting.<sup>126</sup>

To a great extent it would appear that the enactment of s 46 was influenced by American law. As noted earlier, s 6.40 of the MBCA empowers the board of a corporation to authorize distributions<sup>127</sup> subject to restrictions in the articles. Likewise, in Delaware the board of directors has exclusive power to declare a dividend. Section 170(a) of the Delaware

<sup>118</sup> See article 84 and 83 of tables A and B respectively in Schedule 1 of the old Act

<sup>119</sup> See articles 85 and 84 of tables A and B respectively in Schedule 1 of the old Act

<sup>120</sup> *Bond v Barrow Haematite Steel Co* [1902] 1 Ch 353. See also M S Blackman, R D Jooste and G K Everingham *et al* Volume 1 op cit note 115 at 5 – 118

<sup>121</sup> *ibid*

<sup>122</sup> See articles 89 and 88 of Tables A and B respectively in Schedule 1 of the old Act.

<sup>123</sup> See articles 59 and 60 of Tables A and B respectively in Schedule 1 of the old Act.

<sup>124</sup> PL. Davies ‘*Gower and Davies’ Principles of Modern Company Law*’ 8ed (2008) 285

<sup>125</sup> Articles 30(2) and 69(2) of the UK Draft model articles for private companies and public companies respectively

<sup>126</sup> PL. Davies ‘*Gower and Davies’ Principles of Modern Company Law*’ op cit note 124 at 285-286

<sup>127</sup> The definition of ‘distribution’ in s 1.40(6) of the Model Business Corporations Act bears a strong resemblance to the definition of a ‘distribution’ in the Act and it includes the declaration or payment of a dividend.

General Corporations Law provides that ‘the directors of every corporation, subject to any restrictions contained in its certificate of incorporation, may declare and pay dividends upon the shares of its capital stock...’ Section 254U of the Australian Corporations Act also provides that the directors may determine that a dividend is payable and that the board may fix, the amount of the dividend, the time for payment and the method of payment. However unlike s 46 of the Act which is an unalterable provision, s 254U of the Australian Corporations Act is a ‘replaceable rule’ and thus Australian companies have the flexibility to alter the power dynamic between the board and shareholders regarding the power to authorise distributions. In South Africa a company may not completely exclude the power conferred on directors by s 46; as discussed earlier the most that could be done is to impose a higher standard, greater restriction or more onerous requirement than would otherwise apply to the company as envisaged by s 15(2)(a)(iii).

While it may be desirable to empower the board of a company to authorise dividend payments, it would have been desirable to give companies the flexibility to decide whether they want their board to have this power in the first place, and to impose whatever restrictions or conditions or requirements they deem necessary regarding distributions.

#### ***3.4.4 Incurrence of and forgiveness or waiver of debts or other obligations***

A company makes a distribution if it incurs a debt or other obligation for the benefit of one or more of its shareholders or a shareholder of another company with the same group of companies.<sup>128</sup> It has been said that, ‘it is unclear whether the incurring of a non-monetary obligation by a company for example, to render a service or to refrain from doing something, will also constitute a distribution and, if so, how it will be quantified.’<sup>129</sup> The answer to this question is not certain but, it is submitted that paragraph (b) of the definition of ‘distribution’ makes no distinction between monetary and non-monetary obligations. Hence it is arguable that it refers to the incurrence of *any* obligation including a non-monetary obligation.

It is further submitted that a loophole could arise if it were it to be held that the incurrence of a non-monetary obligation is not a distribution. It must be noted that one of the principles underlying the regulation of distributions is to ‘ensure that the rights of creditors are not endangered.’<sup>130</sup> To this end ‘the primary form of regulation in favour of creditors is

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<sup>128</sup> Paragraph (b) of the definition of ‘distribution’ in section 1 of the new Act

<sup>129</sup> K Van der Linde ‘The regulation of distributions to shareholders’ op cit note 64; See also R Jooste ‘Corporate Finance’ in FHI Cassim, MF Cassim, R Cassim *et al* op cit note 36 at 268

<sup>130</sup> K Van der Linde ‘The regulation of distributions to shareholders’ op cit note 64 at 484

the imposition of financial restrictions on distributions.<sup>131</sup> Hence one of the requirements for a distribution is that a company must not make a distribution unless it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the distribution.<sup>132</sup> While the incurrence of an obligation to perform a service or, to refrain from doing something may not sound in money, it is conceivable that the actual performance of the service itself or refraining from doing something may come at a cost to the company. This may in turn impact on the company's solvency and liquidity. Therefore, excluding the incurrence of non-monetary obligations – which may negatively impact on a company's financial position – from the definition of a 'distribution' could affect the protection of creditors' interests.

In light of the above it is submitted that the definition of a distribution must be taken to include not only the incurrence of monetary obligations, but also non-monetary obligations with the result that a company will be required to take into account the cost implications, and the impact thereof on its financial position of any decision to incur a non-monetary obligation. Of course if the incurrence of a particular non-monetary obligation has no cost implications and, therefore will not impact on a company's financial position, the company may proceed with the distribution because then all things being equal, it will reasonably appear that the company will satisfy the solvency and liquidity test after the distribution.

Distributions whereby a company forgives or waives a debt or other obligation owed to it by one or more of its shareholders or a shareholder of another company within the same group of companies, do not seem to raise any serious issues regarding the balance of power between shareholders and the board of directors and also pertaining to the protection of shareholders' interests. Therefore, no further discussion of these types of distributions will be undertaken in this thesis.

### ***3.4.5 Solvency & liquidity test and protection of preference shareholders***

As noted earlier the solvency and liquidity test is one of the requirements that must be satisfied by a company before it can make a distribution. One of the criticisms that have been

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<sup>131</sup> Kathleen van der Linde 'Aspects of the regulation of share capital and distributions to shareholders' op cit note 110 at 15

<sup>132</sup> Section 46(1)(b) of the new Act

levelled at this requirement is that it undermines the protection of preferent shareholders' interests.<sup>133</sup> This arises from the qualification contained in s 4(2)(c) to the effect that,

‘unless the Memorandum of Incorporation of the company provides otherwise, when applying the test in respect of a distribution contemplated in paragraph (a) of the definition of ‘distribution’ in section 1, a person is not to include as a liability any amount that would be required, if the company were to be liquidated at the time of the distribution, to satisfy the preferential rights upon liquidation of shareholders whose preferential rights upon liquidation are superior to the preferential rights upon liquidation of those receiving the distribution.’

Effectively this provision undermines the protection of preferential dissolution rights of shareholders if the distribution takes the form of a transfer of money or property as contemplated in paragraph (a) of the definition of distribution. If the MOI does not provide otherwise, those applying the solvency liquidity test in that context do not have to take into account the amount required to satisfy the preferential rights of preference shareholders.<sup>134</sup> This entails that preference shareholders who wish to protect their interests would need to take steps to amend the company's MOI so that it includes a provision requiring those applying the solvency and liquidity test to take into account the amount required to satisfy the preferential rights of preference shareholders. It is submitted that this is not satisfactory because the preference shareholders needing protection may not be able to muster the sufficient number of votes required to amend the company's MOI.

In light of the express exclusion by s 4(2)(c) of the preference rights of preference shareholders in the context of paragraph (a) distributions, it would seem that the rights of preference shareholders must be taken into account if the distribution were in the form of an incurrence of a debt, or the forgiveness or waiver of a debt as contemplated in paragraphs (b) and (c) of the definition of a distribution.<sup>135</sup> It is of note that the wording of s 4(2)(c) is similar to the wording of s 6.40(c) of the MBCA but the latter provision actually protects the preferential dissolution rights of shareholders<sup>136</sup> by providing that:

No distribution may be made if, after giving it effect:

(1) the corporation would not be able to pay its debts as they become due in the usual course of business; or

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<sup>133</sup> R Jooste op cit note 66 at 643; K Van der Linde ‘The solvency and liquidity approach in the Companies Act 2008’ (2009) *TSAR* 224 at 232-233

<sup>134</sup> *ibid*

<sup>135</sup> FHI Cassim, MF Cassim, R Cassim *et al* op cit note 37 at 280

<sup>136</sup> C Stein and G Everingham op cit note 2 at 186

(2) the corporation's total assets would be less than the sum of its total liabilities *plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution* (writer's emphasis).

Section 6.40(c) does not restrict itself to a particular type of distribution unlike our s 4(2)(c) which deals only with paragraph (a) distributions – transfers of money or other assets of the company.

The preferential rights of shareholders in the context of distributions are also protected in New Zealand. Section 52(4) of the New Zealand Corporations Act 105 of 1993 provides as follows:

In applying the solvency test for the purposes of this section and section 56<sup>137</sup>,—

- (a) debts includes fixed preferential returns on shares ranking ahead of those in respect of which a distribution is made (except where that fixed preferential return is expressed in the constitution as being subject to the power of the directors to make distributions), but does not include debts arising by reason of the authorisation; and
- (b) liabilities includes the amount that would be required, if the company were to be removed from the New Zealand register after the distribution, to repay all fixed preferential amounts payable by the company to shareholders, at that time, or on earlier redemption (except where such fixed preferential amounts are expressed in the constitution as being subject to the power of directors to make distributions); but, subject to paragraph (a), does not include dividends payable in the future.

It is submitted that the new Act ought to have followed the example of s 6.40(c) of the MBCA or, s 52(4) of the New Zealand Corporations Act 105 of 1993 both of which are quite clear that the preferential liquidation rights of shareholders which are superior to the rights of those shareholders receiving the distribution are to be treated as a liability when applying the solvency and liquidity test. If a company issues preference shareholders with superior liquidation rights the holders of such stock are entitled to expect that the MOI will protect their rights unless the shareholders themselves agree to forego such protection.<sup>138</sup>

### **3.4.6 Liability for unlawful distributions**

It is important to note that one of the changes brought about by the new Act is that, unlike the old Act which only imposed liability on directors for unlawful share repurchases but not for unlawful payments<sup>139</sup>, the new Act imposes liability on directors for unlawful distributions

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<sup>137</sup> Sections 52 and 56 of the New Zealand Corporations Act 105 of 1993 deal with distributions to shareholders and the recovery of unlawful distributions respectively.

<sup>138</sup> JJ. Hanks, Jr op cit note 3 at 149

<sup>139</sup> Compare s 86 and s 90 of the old Act

including unlawful payments.<sup>140</sup> This is a positive change. Since directors now generally have the power to authorise distributions without shareholder approval it is important that they are held accountable for any unlawful distributions and not just for unlawful share repurchases. The liability of directors for unlawful distributions in terms of the new Act and the shortcomings of the new Act in this regard are considered in greater detail elsewhere in this thesis.<sup>141</sup>

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<sup>140</sup> Sections 46(6) read with s 77(3)(e)(vi) of the new Act

<sup>141</sup> See chapter 4 para 4.4.2.2



## CHAPTER 4: DIRECTORS' DUTIES AND LIABILITY

### 4.1 Introduction

The previous chapter highlighted how the new Act vests increased powers on the board of directors in the area of corporate finance. The question that immediately arises in the light of the increased powers of directors is whether, and how, the new Act makes directors accountable for the exercise of those powers. This question is relevant to the topic of this thesis as it relates to the protection of shareholders. Power without accountability invites abuse of that power. Therefore those to whom greater power has been given must be held accountable for the exercise of that power and, it is generally accepted that 'with great power comes great responsibility.'<sup>1</sup> Hence the discussion in this chapter will focus on the responsibilities imposed on directors, as well as the measures in the new Act designed to make directors accountable to shareholders.

The focus of the discussion in this chapter is the statutory duties of directors. Also discussed is the liability imposed on directors in terms of s 77 of the new Act for breach of these duties as well as the directors' liability in relation to specific company transactions such as distributions and share issues. Other related provisions concerning the indemnification of directors as well as those provisions providing for relief from liability will also be discussed.

### 4.2 The agency problem and statutory directors' duties

The fact that the new Act has shifted power from shareholders to directors is a matter of concern from a corporate governance perspective because it raises the specter of the age-old problem of conflict of interests or, what economists refer to as the agency problem.<sup>2</sup> As mentioned earlier,<sup>3</sup> the agency problem arises from the fact that the directors who manage and control the company may be motivated to act in their own selfish interests at the expense of the shareholders. This possibility imposes 'agency costs' on the shareholders in that they have to monitor the behavior of the directors. Research has shown that these agency costs are likely to increase where the agent has to undertake tasks of greater complexity and where

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<sup>1</sup> C Stein & G Everingham *The New Companies Act Unlocked* (2011) 255. See also Monks and Minnow *Power and Accountability* available at <http://www.lens-library.com/power/chapter3.html#section2>, accessed on 21 February 2014; *Australian Securities and Investments Commission v Healey* [2011] FCA 717 at para 14

<sup>2</sup> R Kraakman, J Armour & P Davies et al *The Anatomy of Corporate Law-A Comparative and Functional Approach* 2 ed (2009) 35

<sup>3</sup> See discussion in para 1 of Chapter 1

he/she is given greater discretion.<sup>4</sup> Since the new Act gives greater powers and hence discretion to company directors there is concern that the new Act could leave shareholders in a worse position than they were under the old Act. Therefore, it is important to establish whether the new Act has put in place mechanisms to protect shareholders against self-serving or negligent actions of directors.

One of the strategies employed by corporate law in an attempt to constrain conflicts of interest is the imposition upon directors of fiduciary duties to the company.<sup>5</sup> It has been said that:

“The law has tried to answer this question of agency costs by developing its highest standard of behaviour, the fiduciary standard, and applying it to those who hold and manage property on behalf of others. This standard applies to several different players in the process of establishing corporate behaviour, including the board of directors.”<sup>6</sup>

Apart from the fiduciary duties, the common law also attempts to make directors accountable to the shareholders by imposing upon them the duty to act with reasonable care and skill in the management of the company’s affairs.<sup>7</sup>

It is not intended here to engage in a comprehensive discussion of the directors’ common law duties. What is important to note is that a prominent feature of the new Act is that it restates the common law fiduciary duties of directors as well as the duty to exercise reasonable care and skill thereby giving them statutory force.<sup>8</sup>

What follows below is a brief discussion of the fiduciary duties as well as the duty of care and skill as restated in the new Act. To give context to these statutory duties the equivalent common law duties will also be briefly discussed. Also discussed is the liability of directors for breach of these statutory duties.

### **4.3 Statutory directors’ duties**

#### **4.3.1 Duty to avoid a conflict of interest**

The relevant provisions in the new Act concerning directors’ duties are sections 75 and 76. Both sections have a bearing on the directors’ duty to avoid a conflict of interest. Section

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<sup>4</sup> Ibid at 36

<sup>5</sup> *Robinson v Randfontein Estates GM Co Ltd* 1921 AD 168 at 177-178; See also *Sibex Construction (SA) Pty Ltd v Injectaseal CC* 1988(2) SA 54 (T) 65

<sup>6</sup> Monks and Minnow *Power and Accountability* op cit note 1

<sup>7</sup> *African Claim and Land Co Ltd v W J Langermann* 1905 TS 494 at 504; *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980(4) SA 156(W) at 166

<sup>8</sup> FHI Cassim, MF Cassim & R Cassim *et al Contemporary Company Law* 2ed (2012) at 507

76(2)(a) is discussed here while s 75 will be discussed below under the duty to disclose personal financial interests. Section 76(2)(a) provides as follows:

- ‘A director of a company must-
- (a) not use the position of director, or any information obtained while acting in the capacity of a director-
- (i) to gain an advantage for the director, or for another person other than the company or a wholly-owned subsidiary of the company; or
- (ii) to knowingly cause harm to the company or a subsidiary of the company;’

At the core of the above quoted provision is the directors’ duty of loyalty and fidelity to the company which is the essence of the common law fiduciary directors’ duty to avoid a conflict of interest.<sup>9</sup> Although at first sight it may appear as if s 76(2)(a) is equivalent to the common law fiduciary duty to avoid a conflict of interest, it must be noted that the scope of the statutory duty is wider than the common law duty. This is because the statutory duty in s 76(2)(a) is owed to the company and to that company’s wholly owned subsidiary, on the other hand at common law a director of a holding company does not owe a fiduciary duty to its subsidiary company.<sup>10</sup>

#### **4.3.2 General duty of disclosure**

Section 76(2)(b) imposes upon directors a general duty to disclose to the board information which is material to the company. The section provides as follows:

- ‘(2) A director of a company must-
- (b) communicate to the board at the earliest practicable opportunity any information that comes to the director’s attention, unless the director-
- (i) reasonably believes that the information is-
- (aa) immaterial to the company; or
- (bb) generally available to the public, or known to the other directors; or
- (ii) is bound not to disclose that information by a legal or ethical obligation of confidentiality.’

Section 76(2)(b) appears to be a restatement of the common law fiduciary duty to disclose information that is material to the company, in particular the fair dealing rule.<sup>11</sup> The fair dealing rule requires a director to *inter alia*, reveal any information which he has, and knows

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<sup>9</sup> FHI Cassim, MF Cassim & R Cassim *et al* op cit note 8 at 514-515. The common law directors’ fiduciary duty to avoid a conflict of interest was distilled into two related principles namely, the no-conflict rule and the no profit rule. The former rule entailed that the director had a duty to avoid a conflict of personal interests while the import of the latter rule was that the director had a duty not to make a profit from his position as a director. See for example *Phillips v Fieldstone* 2004(3) SA 465 (SCA) 479 para 31

<sup>10</sup> *R v Milne and Erleigh* (7) 1951(1) SA 791 (A) 828

<sup>11</sup> FHI Cassim, MF Cassim & R Cassim *et al* op cit note 8 at 554

that those acting for the company do not have, if it is information likely to influence the company's decision in a particular matter.<sup>12</sup>

Section 76(2)(b) is couched in very wide terms; it requires a director to disclose *any* information that comes to the directors' attention. Despite its wide terms, it would appear that the defences provided in sub-paragraphs (i) and (ii) of that section could make it relatively easy for wayward directors to circumvent the duty.<sup>13</sup>

#### **4.3.3 Duty to disclose personal financial interests**

Apart from requiring directors to disclose any information that is material to the company, section 75(5) of the new Act also specifically requires a director to disclose a personal financial interest which the director or any person related to him/her has in respect of a matter that is to be considered at a meeting of the board of directors. In terms of s 75(5)(a) and (b) the director in question must disclose the interest and its general nature before the matter is considered by the board and, he must also disclose any material information relating to the matter known to him or her. Having made that disclosure, the director is then required to recuse himself as per s 75(5)(d) and (e) from the board meeting wherein the matter in respect of which he or a person related to him/her has a personal financial interest will be considered. A director must not, as per s 75(5)(g), execute a document on behalf of the company in relation to a matter in which he has a personal financial interest unless he is specifically requested or directed to do so by the board. Section 75(6) further provides that,

‘If a director of a company acquires a personal financial interest in an agreement or other matter in which the company has a material interest, or knows that a related person has acquired a personal financial interest in the matter, after the agreement or other matter has been approved by the company, the director must promptly disclose to the board, or to the shareholders in the case of a company contemplated in subsection (3), the nature and extent of that interest, and the material circumstances relating to the director or related person's acquisition of that interest.’

Section 75 embodies the common law fiduciary duty of a director to avoid putting himself in a situation where his personal interests stand in conflict, or potential conflict, with his/her duties to the company.<sup>14</sup>

One major difference between the statutory duty and the common law duty relates to the consequences for breach of the duty. At common law if a director breaches his duty by

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<sup>12</sup> *Novick v Comair Holdings Ltd* 1979 (2) SA 116 (W) 153.

<sup>13</sup> C Stein & G Everingham op cit note 1 at 247. See also P Delpont *The New Companies Act Manual* 2ed (2011) 95

<sup>14</sup> *Robinson v Randfontein Estates GM Co Ltd* supra note 5 at 177-178

acting on behalf of the company in a matter in which he has an interest that conflicts with his duty or, by failing to disclose his interest, the contract is voidable at the instance of the company as against the director or a third party who had knowledge of the director's breach of duty.<sup>15</sup> On the other hand the gist of s 75(7)(b) is that where a transaction is approved without the required disclosure of a directors' personal financial interest, the transaction in question would be valid only if it has subsequently been ratified by an ordinary resolution of the shareholders following disclosure of the interest or, if the transaction is declared valid by a court consequent to an application by an interested person in terms of s 75(8). In other words, the transaction is not valid unless any one of the foregoing conditions is met.

The new Act, much like ss 234 to 241 of the old Act, generally requires that the disclosure be made to the board of directors of the company.<sup>16</sup> Disclosure of the interest to the company's shareholders is not required except in the case of a company having only one director where the director is not the only shareholder.<sup>17</sup> At common law a director is required to disclose any interest he has in a proposed company contract to the shareholders in general meeting.<sup>18</sup> The only exception to this rule is that the company's articles may authorize a director to act for the company in such matters if he discloses his interest to the other board members.<sup>19</sup> From a shareholder's perspective the statutory position requiring disclosure only to the board of directors and not the general meeting of shareholders raises the concern that the 'disinterested' board members tasked with deciding on the interest of one of their own may not exercise their minds independently.<sup>20</sup> In other words the directors may be more inclined to decide in favour of a fellow board member.

However, this concern must be balanced against the need to ensure that companies are able to conclude deals with speed. The time consuming requirement for disclosure to and approval by shareholders in general meeting may be counterproductive.<sup>21</sup> The general practice of companies under the old corporate law regime whereby they included a provision

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<sup>15</sup> MS Blackman, RD Jooste & GK Everingham *et al Commentary on the Companies Act* (2002) Volume 2 at 8-132 to 133

<sup>16</sup> Section 75(4) read with s 75(7) of the new Act. See also P Delport, Q Vorster, D Burdette *et al Henochsberg on the Companies Act, 71 of 2008* (2011) Volume 1 at 287-288; FHI Cassim, M F Cassim & R Cassim *et al op cit* note 8 at 572

<sup>17</sup> Section 75(4) of the Companies Act 71 of 2008

<sup>18</sup> MS Blackman, RD Jooste and GK Everingham *et al op cit* note 15 at 8-327

<sup>19</sup> *Ibid*

<sup>20</sup> *Woolworths Ltd v Kelly* (1991) 4 ACSR 431 435 CA(NSW)

<sup>21</sup> MS Blackman, RD Jooste, GK Everingham *et al op cit* note 15 at 8-328

in their articles permitting disclosure to the board of directors<sup>22</sup> instead of the general meeting was a pragmatic one. Accordingly, s 75 appears to be satisfactory.

#### **4.3.4 Duty to act in good faith, for a proper purpose and in the best interests of the company**

One of the most important common law fiduciary duties is that a director has a duty to act *bona fide* in the best interests of the company.<sup>23</sup> The duty to act *bona fide*, or in good faith, is a subjective one requiring the director to act honestly in what he/she considers, not what the court considers, to be in the best interests of the company.<sup>24</sup> It is an all-encompassing duty extending to the exercise of all the directors' powers within the company. The director's *bona fides* alone does not suffice; the director in question must also ensure that he acts in what he considers, in good faith, to be in the best interests of the company.<sup>25</sup> It is widely accepted that the concept of 'interests of the company' generally refers to the interests of the shareholders, in their capacity as shareholders, as a general body.<sup>26</sup>

The common law fiduciary duty to act *bona fide* in the best interests of the company has been restated in section 76(3) of the new Act as follows:

'Subject to subsections (4) and (5), a director of a company, when acting in that capacity, must exercise the powers and perform the functions of director-

- (a) in good faith and for a proper purpose;
- (b) in the best interests of the company; and...

Paragraph (a) couples the duty to act in good faith with the duty to exercise the power for a proper purpose. The duty to act for a proper purpose derives from the common law fiduciary duty of directors not to exercise their powers for unauthorised or collateral purposes.<sup>27</sup> The common law duty requires directors to exercise their powers only for the purposes for which the power was granted. It has been observed, and rightly so, that section 76(3)(a) of the new Act is declaratory of the common law and as such it does not change this aspect of the common-law fiduciary duties of directors.<sup>28</sup> Similarly s 76(3)(b) does not appear to diverge from the common law duty to act in the best interests of the company.

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<sup>22</sup> *ibid*

<sup>23</sup> *Da Silva v CH Chemicals (Pty) Ltd* 2008(6) SA 620 (SCA) 627

<sup>24</sup> *Re Smith & Fawcett Ltd* [1967] CH 254 at 268

<sup>25</sup> *Australian Growth Resources Corporation Pty Ltd v Van Reesema* (1988) 13 ACLR 261 271 SC(A)

<sup>26</sup> *MS Blackman, RD Jooste & GK Everingham et al* op cit note 15 at 8-67

<sup>27</sup> *Samuel v President Brand Gold Mining Co Ltd* 1969(3) SA 629 (A) at 678; *Hogg v Cramphorn Ltd* [1967] Ch 254

<sup>28</sup> *FHI Cassim, MF Cassim & R Cassim et al* op cit note 8 at 525

#### 4.3.5.1 Duty to act with care, skill and diligence

Apart from the common law director's fiduciary duties, the common law duty requiring directors to exercise their powers with reasonable care and skill<sup>29</sup> is another tool designed to make directors accountable to shareholders. The duty is owed to the company<sup>30</sup> and, while it is aimed at the protection of the company it also ultimately, albeit indirectly, protects the shareholders.<sup>31</sup> The principles pertaining to the director's duty of care and skill were largely developed by the English courts in cases such as *In re City Equitable Fire Insurance Co Ltd*,<sup>32</sup> *In re Brazilian Rubber Plantations and Estates Ltd*<sup>33</sup> and *Lagunas Nitrate Co v Lagunas Syndicate*.<sup>34</sup>

In the case of *In re Brazilian Rubber Plantations and Estates Ltd*<sup>35</sup> the court held that a director's duty requires him 'to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience. He is... not bound to bring any special qualifications to his office.' The court further held that the director must use reasonable care in conducting the company's business and, in this respect reasonable care 'must be measured by the care an ordinary man might be expected to take in the same circumstances on his own behalf.'<sup>36</sup> In the case of *In re City Equitable Fire Insurance Co Ltd*<sup>37</sup> the court said *inter alia*, 'a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience...A director is not bound to give continuous attention to the affairs of his company.'

The decisions of English courts discussed above influenced the development of South African law pertaining to the director's duty of care and skill. For instance, in the leading South African case on the subject, *Fisheries Development Corporation of SA Ltd v Jorgensen*,<sup>38</sup> Margo J noted that the principles developed by the English courts were of guidance to South African courts. He distilled the principles regarding a director's duty of care and skill from the English cases and observed *inter alia* that, '[n]owhere are his duties and qualifications listed as being equal to those of an auditor or accountant. Nor is he

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<sup>29</sup> *Fisheries Development Corporation of SA Ltd v Jorgensen* supra note 7 at 165-166 and also *In re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407 at 427

<sup>30</sup> *Ex parte Stubbs NO: In re Wit Extension Ltd* 1982 (1) SA 526 (W) at 532

<sup>31</sup> D Botha & R Jooste 'A critique of the recommendations in the King Report regarding a director's duty of care and skill' (1997) 114 SALJ 65 at 69

<sup>32</sup> *In re City Equitable Fire Insurance Co Ltd* supra note 29

<sup>33</sup> *In re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425

<sup>34</sup> *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392

<sup>35</sup> *In re Brazilian Rubber Plantations and Estates Ltd* supra note 33 at 437

<sup>36</sup> *ibid*

<sup>37</sup> *In re City Equitable Fire Insurance Co Ltd* supra note 29 at 428 - 429

<sup>38</sup> *Fisheries Development Corporation of SA Ltd v Jorgensen* supra note 7 at 165

required to have special business acumen or expertise, or singular ability or intelligence...He is nevertheless expected to exercise the care which can reasonably be expected of a person with his knowledge and experience...A director is not liable for mere errors of judgment.’<sup>39</sup>

It can be seen from the foregoing that the test for the degree of care and skill required at common law is partly objective, that is the care which *can be reasonably be expected* from a person with his knowledge and experience (writer’s emphasis). The test is also partly subjective to the extent that the particular director’s knowledge and experience influences the level of care that can be expected of him.<sup>40</sup> Notwithstanding this dual nature of the common law test of care and skill, ‘it is generally accepted that ...the common law duty of care and skill is at heart more subjective than objective – the individual director is considered, and is neither measured against a reasonable person nor against the reasonable director, but what the reasonable thing would have been for such a director to have done.’<sup>41</sup> This overemphasis of the subjective aspect led to the criticism that the common law sets a very low standard of care and skill for directors.<sup>42</sup> It has been said that overemphasizing the skills and experience of the director concerned in a given situation amounts to not setting a standard at all; such a test absolves honest, but sometimes inept, directors from their actions on the basis that they are incapable of performing their duties any better.<sup>43</sup> Indeed the laxity associated with the common law duty of care and skill appears to be borne out by the paucity of cases where directors have been found to have breached the duty.<sup>44</sup>

#### **4.3.5.2 The statutory duty of care, skill and diligence**

Section 76(3)(c) establishes a statutory duty of care, skill and diligence which applies concurrently with the common law duty. Section 76(3)(c) of the new Act provides that:

‘Subject to subsections (4) and (5), a director of a company, when acting in that capacity, must exercise the powers and perform the functions of director- .....

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<sup>39</sup> Ibid at 166

<sup>40</sup> P Delpont *et al Henochsberg on the Companies Act 2008* op cit note 16 at 296; See also R Stevens and P De Beer ‘The duty of care and skill, and reckless trading: remedies in flux?’ (2016) 28 *SA Merc LJ* 250 at 253-254

<sup>41</sup> R Stevens and P De Beer op cit note 40 at 253

<sup>42</sup> See MP Larkin and FHI Cassim ‘Company Law (Including Close Corporations)’ (2003) *Annual Survey of South African Law* 549; D Botha & R Jooste op cit note 31 at 69; E Jones ‘Directors duties: negligence and the business judgment rule’ (2007) 19 *SA Merc LJ* 326 at 335; M Bekink ‘An historical overview of the director’s duty of care and skill: from the nineteenth century to the Companies Bill of 2007’ (2008) 20 *SA Merc LJ* 95 at 98; J Cassidy ‘Models for reform: the director’s duty of care in a modern commercial world’ (2009) *Stell LR* 373 at 383-384

<sup>43</sup> M Bekink ‘An historical overview of the director’s duty of care and skill’ op cit note 42 at 98

<sup>44</sup> D Botha & R Jooste op cit note 31 at 68



- (c) with the degree of care, skill and diligence that may reasonably be expected of a person-
  - (i) carrying out the same functions in relation to the company as those carried out by that director; and
  - (ii) having the general knowledge, skill and experience of that director.’

The test for the standard of care required in terms of s 76(3)(c)(i) and (ii) is not very clear and, it is submitted that Cassidy is correct in observing that the provision is ambiguous.<sup>45</sup> The first leg of the test contained in s 76(3)(c)(i) appears to set an objective standard of care and skill. However, when read together with the second leg of the test contained in s 76(3)(c)(ii) it seems that the first leg is reduced to a subjective standard. Hence divergent views have been expressed concerning the test of care and skill imposed by s 76(3)(c); one view is that the section imposes ‘a less subjective test and a slightly more demanding standard of care on directors...than the common law.’<sup>46</sup> Another view is that the section imposes an overly subjective standard similar to the common law test which is dependent on the level of knowledge, skill and experience of the director whose conduct is in question.<sup>47</sup>

It is submitted that the ambiguity in s 76(3)(c) should be resolved through purposive interpretation which takes into account not only the language of the statute, but also its object and policy, that is its purpose as well as its background.<sup>48</sup> Purposive interpretation would be in accord with s 5(1) of the Act which provides that the Act ‘must be interpreted and applied in a manner that gives effect to the purposes set out in section 7’ (writer’s emphasis). One of the purposes of the new Act is to promote the development of the South African economy by ‘encouraging transparency and high standards of corporate governance and also to encourage the efficient and responsible management of companies,’<sup>49</sup>(writer’s emphasis). It is submitted that the realisation of this objective would be hindered if the courts were to interpret s 76(3)(c) as imposing an overly subjective standard of care and skill similar to the common law standard. As noted earlier the subjective approach at common law has been criticised for setting the bar very low in terms of the degree of care and skill.<sup>50</sup>

Therefore s 76(3)(c) must be interpreted in such a way that it imposes a stricter standard of care and skill. This would entail that s 76(3)(c)(i) imposes a minimum objective

<sup>45</sup> J Cassidy op cit note 42 at 376

<sup>46</sup> FHI Cassim, MF Cassim & R Cassim *et al* op cit note 8 at 558; See also P Sutherland ‘The state of company law in South Africa’ (2012) 1 *University of Stellenbosch Law Review* 157 at 172

<sup>47</sup> JJ Du Plessis ‘A comparative analysis of directors’ duty of care, skill and diligence in South Africa and in Australia’ in *Modern Company Law for a Competitive South African Economy* (2010) 263 at 269-270

<sup>48</sup> *Venter v R* 1907 TS 910 914-915; *Dadoo v Krugersdorp Municipal Council* 1920 AD 530; *Jaga v Donges* 1950 (4) SA 653 (A) 662-663

<sup>49</sup> Section 7(b)(iii) and (j) of the Companies Act 71 of 2008

<sup>50</sup> V Finch ‘Company directors: who cares about care and skill’ (1992) 55 *Modern Law Review* 179 at 200

standard against which the conduct of every director will be measured irrespective of his level of skill and experience and, the subjective elements contained in s 76(3)(c)(ii) would serve to enhance the standard where the director concerned possesses greater skills and/or experience. Such a conclusion is similar to what is contended for by Sutherland<sup>51</sup> and others,<sup>52</sup> although Sutherland does not explicitly refer to purposive interpretation as the means to attain such an end.

It must also be kept in mind that '[T]he decision of the Department of Trade and Industry in South Africa (the DTI) to review and modernize company law in this country was based on *the need to bring our law in line with international trends ...*'<sup>53</sup> It was said that one of the objectives of the new company law should be to promote the competitiveness and development of the South African economy by ensuring *compatibility and harmonisation with best practice jurisdictions internationally*.<sup>54</sup> Interpreting s 76(3)(c) in such a way that it imposes a stricter standard of care and skill would align South African corporate law with the trend in other common law jurisdictions, such as England and Australia, where they have moved away from the overly subjective test common law test of care and skill to more stricter standards.<sup>55</sup>

Significantly, the wording of s 76(3)(c) is similar to the wording of s 174 of the UK Companies Act 2006. Section 174 provides as follows:

- (1) A director of a company must exercise reasonable care, skill and diligence.
- (2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with—
  - (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
  - (b) the general knowledge, skill and experience that the director has

Section 174(2) establishes a dual objective/subjective test of knowledge, skill and experience. The view is held that s 174(2)(a) sets a minimum objective standard of knowledge, skill and experience, which standard may then be raised by the subjective element of the test – paragraph (b) of the same section – if the director in question has any special knowledge,

<sup>51</sup> P Sutherland op cit note 46 at 172

<sup>52</sup> J Cassidy op cit note 42 at 386

<sup>53</sup> Department of Trade and Industry Policy Paper *South African Company Law for the 21st Century* (GN 1183 in GG 26493 of 23 June 2004) at 3

<sup>54</sup> Ibid at 9. See also the Memorandum on the objects of the Companies Bill 2008 [B 61 - 2008] para 1.1.1

<sup>55</sup> M Bekink 'An historical overview of the director's duty of care and skill' op cit note 42 at 99; M Havenga 'The Business judgment rule – should we follow the Australian example?' (2000) 12 *SA Merc LJ* 25 at 26; JS McLennan 'Directors fiduciary duties and the 2008 Companies Bill' (2009) 1 *TSAR* 184 at 186

skill and experience.<sup>56</sup> The approach to s 174(2) is significant in the context of our s 76(3)(c) given that in terms of s 5(2) of the new Act a South African court may, to the extent appropriate, consider foreign company law when interpreting the Act.

Given the uncertainties of statutory interpretation, it is submitted that the best way to resolve the ambiguity in s 76(3)(c) is for the legislature to amend s 76(3)(c) of the new Act along the lines of s 60(1A) of our Banks Act 94 of 1990 [hereafter ‘the Banks Act’] which imposes a duty of care and skill on bank directors.<sup>57</sup> Section 60(1A)(c) of the Banks Act provides that:

‘Each director, chief executive officer and executive officer of a bank owes a duty towards the bank to possess and maintain the knowledge and skill that may reasonably be expected of a person holding a similar appointment and carrying out similar functions as are carried out by the director, chief executive officer or executive officer of that bank.’

This is followed up by s 60(1A)(d) which provides, unambiguously, that:

‘Each director, chief executive officer and executive officer of a bank owes a duty towards the bank to exercise such care in the carrying out of his or her functions in relation to that bank as may reasonably be expected of a diligent person who holds the same appointment under similar circumstances, and who possesses both the knowledge and skill mentioned in paragraph (c) and any such additional knowledge and skill as the director, chief executive officer or executive officer in question may have.’

Section 60(1A) ‘clarifies the uncertainty at common law relating to the test applicable to determine whether or not the duty has been discharged. Common-law interpretations favour a subjective test, whereas s 60(1A)(c) and (d) introduce an objective test for both the duty of skill and the duty of care...’<sup>58</sup> Section 60(1A)(d) read with s 60(1A)(c) of the Banks Act explicitly lays down a minimum objective standard of care and skill expected of a director namely, that which may *reasonably be expected of a diligent person who holds the same appointment under similar circumstances*. It also makes clear that a director who possesses additional knowledge and skills will be measured against the standard of care and skill that can be reasonably expected of a diligent person who holds the same appointment under similar circumstances, and who possess both the knowledge and skill mentioned in paragraph (c) *and any such additional and knowledge*.

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<sup>56</sup> L Sealy and S Worthington *Sealey’s Cases and Materials in Company Law* 9ed (2009) 331; See also England and Wales and Scottish Law Commissions Report (Law Com No. 261) *Company directors: regulating conflicts of interest and formulating a statement of duties* (1999), para 5.20, available at [http://lawcommission.justice.gov.uk/docs/lc261\\_Company\\_Directors.pdf](http://lawcommission.justice.gov.uk/docs/lc261_Company_Directors.pdf), accessed on 13 February 2015

<sup>57</sup> MP Larkin and FHI Cassim op cit note 42 at 550-552

<sup>58</sup> J De Jager ‘Comments on the effects of section 40 of the Banks Amendment Act 19 of 2003 on section 60 of the Banks Act 94 of 1990’ (2005) 17 *SA Merc LJ* 170 at 174

It is submitted that amending s 76(3)(c) by adopting the wording of s 60(1A) of the Banks Act would address the uncertainty surrounding the interpretation of s 76(3)(c) by removing the ambiguity in s 76(3)(c)(ii). This would ensure that the courts will not impose a subjective standard on the statutory duty of care and skill thereby condemning it to suffer from the same weaknesses that afflict the common law duty.

The forgoing discussion briefly outlined how the new Act has restated the directors' duties found at common law. Highlighted in the discussion were some similarities and differences between the common law duties and the statutory duties. A restatement of these common law duties in the new Act would be of no significance to shareholder protection if no liability was imposed upon the directors for breach of those duties. It is therefore important to discuss whether, and what liability is imposed by the new Act upon directors for breach of these statutory duties. A discussion of the directors' liability provides insight into whether the new Act imposes appropriate liability for breach of those duties in the light of the increased powers bestowed on the directors by the new Act.

#### **4.4.0 Liability of directors**

##### **4.4.1 Liability of directors in terms of s 77(2)**

Section 77 of the new Act is the global provision dealing with the liability of directors. It is important to note who qualifies as a director in this regard. Section 1 of the Act defines a director as 'a member of the board of a company, as contemplated in section 66, or an alternate director of a company and includes any person occupying the position of a director or alternate director, by whatever name designated.' It has correctly been observed that 'this definition is wide enough to include most types of directors, such as executive and non-executive directors, de facto and de jure directors, alternate directors, nominee directors, ex officio directors and also shadow directors.'<sup>59</sup>

In terms of ss 75 and 76 which deal with directors' duties, as well as s77 which deals with the liability of directors, the term director also includes a prescribed officer; or a person who is a member of a committee of a board of a company, or of the audit committee of a company, irrespective of whether or not the person is also a member of the company's board.<sup>60</sup> Further, a prescribed officer is defined as a person who, despite not being a director of a company, exercises or, regularly participates to a material degree in the exercise of

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<sup>59</sup> FHI Cassim, MF Cassim & R Cassim *et al* op cit note 8 at 510

<sup>60</sup> See sections 76(1) and 77(1) of the new Act

general executive control over and management of the whole or, significant portion, of the business and activities of the company.<sup>61</sup> It is submitted that this aspect of the new Act enhances the protection of shareholders as it casts the net of accountability over an extended class of persons, whether appointed as directors or not, who ‘play an increasingly important role in the functioning of corporate boards.’<sup>62</sup>

Sections 77(2)(a) and (b) specifically deal with the liability of directors for breach of their statutory fiduciary duties and the duty of care and skill as provided for in ss 75 and 76. Section 77(2) provides that,

‘A director of a company may be held liable-

- (a) in accordance with the principles of the common law relating to breach of a fiduciary duty, for any loss, damages or costs sustained by the company as a consequence of any breach by the director of a duty contemplated in section 75, 76(2) or 76(3)(a) or (b); or
- (b) in accordance with the principles of the common law relating to delict for any loss, damages or costs sustained by the company as a consequence of any breach by the director of-
  - (i) a duty contemplated in section 76(3)(c) ...’
  - (ii) any provision of this Act not otherwise mentioned in this section; or
  - (iii) any provision of the company’s Memorandum of Incorporation.

The duties referred to in paragraph (a) above are the statutory fiduciary duties<sup>63</sup> while the duty referred to in paragraph (b)(i) above is the statutory duty of care and skill discussed earlier.<sup>64</sup>

Hence directors who breach their statutory duties will be held liable in accordance with the common law principles relating to breach of a duty for any loss, damages or costs sustained by the company as a consequence of any breach by the director of a statutory duty.

It is worth noting that s 77(2)(a) specifically refers to liability ‘for any loss, damages or costs sustained by the company.’ This appears to restrict the liability of directors only to the loss, damages or costs sustained by the company. The provision is silent concerning whether directors would be accountable to the company for any profits that they make in breach of the no-profit rule.<sup>65</sup> At common law a company can recover any profits made by the directors in breach of the no-profit rule even though the company may actually not have

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<sup>61</sup> Regulation 38(1) of the Companies Regulations 2011 read with s 66(10) of the new Act

<sup>62</sup> FHI Cassim, MF Cassim & R Cassim *et al* op cit note 8 at 511-512

<sup>63</sup> See discussion in paragraph 4.3.1 up to and including paragraph 4.3.4

<sup>64</sup> See paragraph 4.3.5.1 above

<sup>65</sup> FHI Cassim, MF Cassim & R Cassim *et al* op cit note 8 at 583. The no-profit rule stipulates that a person who stands in a fiduciary position must not make a profit by use of his office or position and, if he/she does make a profit he/she must account for the profit to the principal unless the principal gives his/her consent for the fiduciary to retain the profit. See for instance *Robinson v Randfontein Estates Gold Mining Co Ltd* supra note 5

suffered any loss in the circumstances; in this regard the company's claim for disgorgement of the profit made in breach of duty is *sui generis*.<sup>66</sup>

The silence of s 77(2)(a) on this aspect creates an ambiguity which leads to uncertainty as to whether the legislature meant to exclude a company's right to recover profits made by directors in breach of their fiduciary duty in circumstances where the profits were not made at the expense of the company.<sup>67</sup> It would not bode well for corporate governance, in particular the protection of shareholders, if directors were to be permitted to keep profits made in breach of their statutory fiduciary duties. Perhaps the better view is that even though the Act is silent on the issue of recovery of profits made in breach of statutory fiduciary duties, these could still be recovered in terms of the common law principle. This would seem to be so since the new Act does not expressly state that the statutory provisions concerning the directors' duties and the liability attaching thereto are in substitution of the common law rules and principles.<sup>68</sup> It is trite law that statutes are to be interpreted in conformity with the common law rather than against it except where and, so far as the statute expressly alters the common law.<sup>69</sup>

Concerning directors' liability for breach of the statutory duty of care, skill and diligence<sup>70</sup>, s 77(2)(b)(i) provides that such a director would be held liable in accordance with the principles of the common law relating to delict for any loss, damages or costs sustained by the company as a consequence of the breach by the director. In this respect the new Act appears to be in line with the common law.

It is to be noted that where directors breach their statutory fiduciary duties or their duty of care and skill, the proper plaintiff to sue the directors' concerned in terms of s 77(2)(a) and (b)(i) is the company since the duties mentioned therein are owed to the company and not the shareholders. However, shareholders are not without means to ensure that redress is made for harm done to the company in situations where those in control of the company fail or, refuse to take remedial action. In such circumstances a shareholder and an extended class of people including, amongst others, directors, prescribed officers and trade

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<sup>66</sup> *Phillips v Fieldstone* supra note 9 at 480; See also *Symington and Others v Pretoria-Oos Privaat Hospital Bedryfs (Pty) Ltd* [2005] 4 All SA 403 (SCA)

<sup>67</sup> FHI Cassim, MF Cassim & R Cassim *et al* op cit note 8 at 583

<sup>68</sup> P Delport *The New Companies Act Manual* op cit note 13 at 90; M Havenga 'Directors' exploitation of corporate opportunities and the Companies Act 71 of 2008' (2013) 2 TSAR 257 at 262;

<sup>69</sup> See *Johannesburg Municipality v Cohen's Trustees* 1909 TS 811 at 823. It also worth noting that s 158 requires a court to develop the common law as necessary to improve the realisation and enjoyment of rights established by the Act when determining a matter brought before it in terms of the new Act.

<sup>70</sup> Section s 76(3)(c)

unions may bring a derivative action in terms of s 165 of the new Act.<sup>71</sup> More will be said about this remedy in the next chapter.

Before proceeding to deal with the liability of directors in terms of s 77(3) it is important to point out that in addition to s 77(2)(b)(i) which deals with the liability of a director for breach of the statutory duty of care, skill and diligence, ss 77(2)(b)(ii) and (iii) also provide that a director may be held liable in accordance with the principles of the common law relating to delict for any loss, damages or costs sustained by the company as a consequence of any breach by the director of any provision of this Act not otherwise mentioned in s 77 or any provision of the company's MOI. Thus the personal liability of directors in terms of s 77 goes beyond the statutory fiduciary duties and the duty of care, skill and diligence imposed by ss 75 and 76.

#### **4.4.2 Liability of directors in terms of s 77(3)**

Section 77(3) deals with the liability of directors in relation to specific corporate transactions. It provides inter alia, that:

‘A director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having-

- (a) acted in the name of the company, signed anything on behalf of the company, or purported to bind the company or authorise the taking of any action by or on behalf of the company, despite knowing that the director lacked the authority to do so;
- (b) acquiesced in the carrying on of the company's business despite knowing that it was being conducted in a manner prohibited by section 22(1);
- (c) been a party to an act or omission by the company despite knowing that the act or omission was calculated to defraud a creditor, employee or shareholder of the company, or had another fraudulent purpose...
- (e) been present at a meeting, or participated in the making of a decision in terms of section 74, and failed to vote against-
- (i) the issuing of any unauthorised shares, despite knowing that those shares had not been authorised in accordance with section 36;
- (ii) the issuing of any authorised securities, despite knowing that the issue of those securities was inconsistent with section 41...
- (v) the provision of financial assistance to a director for a purpose contemplated in section 45, despite knowing that the provision of financial assistance was inconsistent with that section or the company's Memorandum of Incorporation;
- (vi) a resolution approving a distribution, despite knowing that the distribution was contrary to section 46, subject to subsection (4);
- (vii) the acquisition by the company of any of its shares, or the shares of its holding company, despite knowing that the acquisition was contrary to section 46 or 48...

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<sup>71</sup> The extension of the derivative action to other classes of people other than shareholders is a commendable feature of the new Act. It helps to ensure that directors are held accountable.

All the paragraphs in s 77(3) use the word ‘knowing’ hence knowledge on the part of the director is a prerequisite for liability under the section. The term ‘knowing’ as defined in s 1 has an extended meaning. Section 1 provides that the words ‘knowing’, ‘knowingly’ or ‘knows’, when used with respect to a person, and in relation to a particular matter, means that the person either had actual knowledge of the matter, or was in a position in which the person reasonably ought to have had actual knowledge, investigated the matter to an extent that would have provided the person with actual knowledge; or taken other measures which, if taken, would reasonably be expected to have provided the person with actual knowledge of the matter.

#### **4.4.2.1 Liability in relation to issue of shares, provision of financial assistance and distributions**

As mentioned above in the context of directors’ statutory duties, as well as the liability of directors, the term ‘director’ is defined expansively to include other persons such as prescribed officers and members of the board committees or the audit committee irrespective of whether any such persons are also members of the company’s body.<sup>72</sup> However when it comes to the liability of directors for the specific company transactions mentioned in s 77(3)(e)<sup>73</sup>, in particular distributions and the acquisition by the company of its own shares, it would appear that only a director in the strict sense of the word can be held liable.<sup>74</sup> The reason for this is that for liability to attach to a person in relation to a distribution or an acquisition by a company of its own shares, that person must, amongst other requirements, have participated in passing the board resolution authorising the distribution or the share acquisition;<sup>75</sup> and, in terms of ss 46(1)(a)(ii) and 48(2)(a) only board members can vote on such matters.

A concern has been raised that a director who did not participate in making a resolution authorising a distribution may escape liability even though he may have participated in making the subsequent resolution required by s 46(1)(c) whereby the board acknowledges *inter alia* that it has applied the solvency and liquidity test<sup>76</sup> [hereafter ‘the acknowledgement resolution’]. This argument is premised on the fact that the use of the word ‘approved’ in ss 46(6) read with s 77(3)(e)(vi) implies that a director’s liability in relation to a

<sup>72</sup> See sections 75(1); 76(1) and 77(1) of the new Act

<sup>73</sup> See para 4.4.2 where this provision is quoted

<sup>74</sup> K Van der Linde *Aspects of the regulation of share capital and distributions to shareholders* (unpublished LLD thesis, University of South Africa, 2008) 480

<sup>75</sup> Section 77(3)(e)(vi) & (vii) of the Companies Act 71 of 2008

<sup>76</sup> K Van der Linde op cit note 74



distribution depends on the director having participated in making, or failing to vote against, the resolution approving a distribution. Sections 46(6) and 77(3)(e)(vi) do not mention a directors' participation in making the acknowledgement resolution hence it would seem that a director who only participates in making such a resolution, but not the resolution approving a distribution, could escape liability.<sup>77</sup> The argument highlights a loophole in the Act which some directors may seek to exploit in a bid to escape liability. Hence the legislature should look into tightening s 77(3)(e)(vi) to ensure that this argument cannot be raised by a director who only participates in passing the acknowledgement resolution.

Notwithstanding the loophole referred to above, it is submitted that a director who did not participate in making the resolution authorising a distribution or approving a share acquisition by the company, but who participated in making the acknowledgement resolution required by s 46(1)(c) could still be held liable for breaching the duty of care, skill and diligence in terms of s 77(2)(b)(i). In this regard it must be noted that when passing the acknowledgment resolution the board will in effect be acknowledging that it has applied the solvency and liquidity test *and reasonably concluded that the company will satisfy the test immediately after completing the proposed distribution.*<sup>78</sup> Hence before participating in making the acknowledgment resolution it is incumbent upon the director who did not participate in the earlier resolution authorising the distribution or, approving a share acquisition by the company, to satisfy himself/herself concerning the reasonableness of the conclusion arrived at by his fellow board members that the company would satisfy the solvency and liquidity test immediately after the completing the distribution.

Further, it is clear from the tenor of s 76(4)(a)(i) that, in order to discharge his statutory duty of care, skill and diligence a director must *inter alia*, take reasonably diligent steps to become informed about a matter before making a decision in his capacity as a director. Hence a director would breach the statutory duty of care, skill and diligence if he supports the acknowledgement resolution and it turns out that the distribution or, share acquisition was contrary to s 46 because the company fails to meet the solvency and liquidity test immediately after the transaction and, that it was unreasonable at the time of the decision for the board to conclude that the company would satisfy the solvency and liquidity test immediately after completing the transaction. Therefore, even if a director could potentially escape liability under s 77(3)(e)(vi) or (vii) by pleading that he did not participate in the

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<sup>77</sup> *ibid*

<sup>78</sup> Section 46(1)(c) of the new Act

initial resolution authorising the distribution or approving the share acquisition, it is submitted that the director could still be held liable in terms of s 77(2)(b)(i) for failing to act with due care and diligence.

Another point of concern that has been raised by Van der Linde is that the new Act treats the liability of a director in respect of a transaction whereby a company acquires its own shares differently from his/her liability in relation to a distribution.<sup>79</sup> The argument advanced in this regard is that the requirements in 77(4)(a) which are precedent to a directors' liability in terms of s 77(3)(e)(vi) limit a director's liability in relation to a distribution that is contrary to s 46, but the Act does not make these requirements applicable to a directors' liability in terms of s 77(3)(e)(vii) in relation to an acquisition by the company of its own shares in contravention of s 46 or 48. Section 77(4)(a) provides that,

‘...the liability of a director in terms of s 77(3)(e)(vi) as a consequence of the director having failed to vote against a distribution in contravention of section 46 arises only if, (i) immediately after making all of the distribution contemplated in a resolution in terms of section 46, the company does not satisfy the solvency and liquidity test; and (ii) it was unreasonable at the time of the decision to conclude that the company would satisfy the solvency and liquidity test after making the relevant distribution.’

Van Der Linde argues that as a consequence of the above, directors who participate in making a decision approving the acquisition of its own shares by a company in contravention of the solvency and liquidity requirements in s 46 potentially face wider liability than directors involved in an unlawful distribution.<sup>80</sup> She contends that this creates an unjustifiable bias since the payment by a company of a consideration for the acquisition of its own shares is also a distribution.<sup>81</sup>

The argument raised by Van Der Linde is to some extent valid. It is also acknowledged that ss 77(3)(e)(vi) and (vii) as well as s 77(4) of the Act do appear to make a distinction between the liability of a director in relation to a distribution and in relation to a share acquisition respectively. However, it is submitted that sight must not be lost of the fact that the Act does not preclude the possibility that a director who participates in approving a decision for the acquisition by the company of its own shares in contravention of s 46 could be held liable in terms s 77(3)(e)(vi). The latter imposes liability for a distribution in contravention of s 46. It must be noted that in terms of s 48(2), the board of a company may

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<sup>79</sup> K Van der Linde op cit note 74 at 482

<sup>80</sup> Ibid

<sup>81</sup> Ibid

not authorize the acquisition by the company of its own shares unless the decision to do so satisfies the requirements of a distribution in s 46. Moreover, the definition of a distribution in s 1 of the Act includes a payment made by a company for the acquisition of its own shares. Therefore, it follows that where a director participates in making a decision to authorize the acquisition of shares in contravention of s 46, such a director could be held liable not only in terms of s 77(3)(e)(vii), but also in terms of s 77(3)(e)(vi) which relates to a distribution contrary to s 46. If the latter provision is relied upon in proceedings against the director, then s 77(4)(a) could find application and thus also limit the directors' liability in relation to a share acquisition thereby obviating the problem alluded to by Van der Linde.<sup>82</sup>

It is submitted that the reference to s 46 in s 77(3)(e)(vii), which partly gives rise to the bias noted by Van der Linde<sup>83</sup>, is anomalous. The reference to s 46 in this instance is problematic because s 46 deals exclusively with distributions and the 'acquisition' of shares by the company is not in itself a distribution.<sup>84</sup> It is only the payment made by the company for the acquisition of its shares that qualifies as distribution in terms of s 1 of the new Act. It is further submitted that s 77(3)(e)(vii) ought only to have referred to an acquisition that was contrary to s 48 without mentioning s 46 because a director's liability for contravening s 46 – which deals with distributions – is already appropriately taken care of by s 77(3)(e)(vi) which deals with a distribution that contravenes s 46.

Before moving on to other aspects of directors' liability in terms of s 77 it is to be noted that ss 77(4)(b)(i) and (ii) provide that the director's liability in terms of s 77(3)(e)(vi) is limited to the difference between the amount by which the value of the distribution exceeded the amount that could have been distributed without causing the company to fail to satisfy the solvency and liquidity test; and the amount, if any, recovered by the company from persons to whom the distribution was made. It is also noteworthy that s 77(6) provides that the liability of any person in terms of s 77 is joint and several with any other person who may be held liable for the same act. This prevents any one of the wrongdoing directors from avoiding paying the full amount of costs, damages or other amount recoverable in terms of the Act by pleading that the liability should be spread proportionally amongst all the guilty parties.

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<sup>82</sup> *ibid*

<sup>83</sup> *ibid*

<sup>84</sup> R Jooste 'Issues Relating to the regulation of 'distributions' by the 2008 Companies Act' (2009) 126 *SALJ* 627 at 647

### **4.4.3. Relief from liability by the court**

Section 77(5) provides that if the board of a company has made a decision in a manner that contravenes the new Act as contemplated in s 77(3)(e),<sup>85</sup> the company or any director who has been or may be held liable in terms of s 77(3)(e), may apply to a court for an order setting aside the decision of the board.<sup>86</sup> Upon such an application being made to it the court may make an order setting aside the decision in whole or in part, absolutely or conditionally and any further order that is just and equitable in the circumstances, including an order-

- (aa) to rectify the decision, reverse any transaction, or restore any consideration paid or benefit received by any person in terms of the decision of the board; and
- (bb) requiring the company to indemnify any director who has been or may be held liable in terms of this section, including indemnification for the costs of the proceedings under this subsection.<sup>87</sup>

The rationale for a court to make an order in terms of (bb) above has been criticised, and rightly so, for being incomprehensible.<sup>88</sup> As noted earlier, the liability of a director in terms of s 77(3) concerning company transactions such as, amongst others, share issues, share repurchases and distributions is dependent on whether the director in question had knowledge, at the time the transaction was approved, that the transaction was in contravention of the Act. Therefore it is difficult to understand why a company should be directed to indemnify a director in this instance when to start with the director had knowledge<sup>89</sup> that the transaction was contrary to the Act but, despite that knowledge, he failed to vote against the approval of the transaction.<sup>90</sup>

Section 77(9) is another relevant provision concerning the relief of directors from liability by the court. It empowers the court, in any proceedings against a director, other than for wilful misconduct or wilful breach of trust, to relieve the director, either wholly or partly, from any liability set out in s 77, on any terms the court considers just if it appears to the court that-

- (a) the director is or may be liable, but has acted honestly and reasonably; or
- (b) having regard to all the circumstances of the case, including those connected with

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<sup>85</sup> See paragraph 4.4.2 above concerning the liability imposed on a director in terms of s 77(3)(e) for *inter alia*, participating in the making of a decision relating to the issuing of unauthorised shares, or the provision of financial assistance to directors in contravention of s 44 and, the approval of a distribution contrary to s 46

<sup>86</sup> Section 77(5)(a) of the new Act

<sup>87</sup> Section 77(5)(b)(ii)(aa) & (bb) of the new Act

<sup>88</sup> R Jooste op cit note 84 at 648

<sup>89</sup> See the discussion in para 4.4.2 above concerning the extended meaning of the term 'knowing' as defined in s of the new Act.

<sup>90</sup> *ibid*

the appointment of the director, it would be fair to excuse the director.

Section 77(9) only provides relief where the director acted honestly and reasonably and, it does not provide relief from wilful misconduct or wilful breach of trust. To the extent that 77(9) makes it possible for directors to be relieved from liability arising from their negligence it is similar to its predecessor, s 248(1) of the old Companies Act of 1973. A concern from the perspective of shareholder protection is the fact that s 77(9) is much wider in its scope, thus giving directors a much wider berth to escape liability than was previously the case under the old s 248(1). The latter section provided for exemption from liability in any proceedings against directors for negligence, default, breach of duty or breach of trust. By contrast s 77(9) appears to cover even proceedings for gross negligence.<sup>91</sup>

Further, before a court could grant relief from liability in terms of s 248(1) of the old Act the court had to be satisfied that the director had acted honestly and reasonably *and that*, having regard to all the circumstances of the case, including those connected to his appointment, he ought to be fairly excused from liability.<sup>92</sup> On the other hand the new Act requires the court to be satisfied that the director acted honestly and reasonably *or* having regard to all the circumstances of the case, including those connected with the appointment of the director, it would be fair to excuse the director. The fact that the grounds for relief are couched in the alternative in the new Act appears to imply that it is possible for a director to be granted relief even where the director acted unreasonably.<sup>93</sup> It is submitted that this appears to give directors an escape from liability and it does not resonate well with principles of good corporate governance. It also enhances the perception that the new Act has shifted the balance of power between shareholders and directors in favour of the latter.

Another provision related to s 77(9) is s 77(10) of the new Act which provides that a director who has reason to apprehend that a claim may be made alleging that the director is liable, other than for wilful misconduct or wilful breach of trust, may apply to a court for relief, and the court may grant relief to the director on the same grounds as if the matter had come before the court in terms of subsection (9). Section 77(10) also provides directors with an escape route from liability and the concerns discussed above in relation to s 77(9) apply equally to s 77(10).

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<sup>91</sup>C Stein & G Everingham *op cit* note 1 at 254

<sup>92</sup> *ibid*

<sup>93</sup> *Ibid*; See also FHI Cassim, MF Cassim & R Cassim *et al op cit* note 8 at 579

#### **4.4.4 Other liability**

##### **4.4.4.1 Section 20(6)**

The liability of a director in terms of s 77 discussed in the above paragraphs is to the company. Section 20(6) on the other hand empowers each shareholder of a company to bring a claim for damages against any person, including a director, who intentionally, fraudulently or due to gross negligence causes the company to do anything inconsistent with the Act or a limitation, restriction or qualification contemplated in s 20, unless that action has been ratified by the shareholders. In terms of s 20(2) the shareholders may by special resolution ratify any act of the directors which is contrary to any limitation, restriction or qualification in the company's MOI relating to the company's capacity or the authority of the directors to act on behalf of the company. This overrides the common law principle established in *Ashbury Railway Carriage and Iron Co v Richie*<sup>94</sup> that an ultra vires action done on behalf of the company was void and, therefore not capable of being ratified even by the unanimous assent of all the shareholders. However, s 20(3) precludes the ratification of any action that is in contravention of the Act. Hence shareholders may not ratify any action of the directors that is in breach of any of the statutory duties. This is commendable as it ensures that even minority shareholders can hold directors accountable for the observance of their statutory duties.

##### **4.4.4.2 Section 218 (2)**

Section 218(2) is another important provision concerning the liability of directors. It provides that:

‘Any person who contravenes any provision of this Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention.’

It is clear from the repeated use of the word ‘any’ in this section that the provision has a wide reach. Significantly, it exposes directors to personal liability not only to the company, but also to other persons, including shareholders. Although s 218(2) creates an avenue through which shareholders may have recourse against company directors for the recovery of damages, it must be borne in mind that acts of directors which cause harm to shareholders are likely to also cause loss to the company and thus the ‘no reflective loss’ principle may come into play thereby preventing the shareholder from recovering against directors if his loss is reflective of the loss suffered by the company.<sup>95</sup>

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<sup>94</sup> *Ashbury Railway Carriage and Iron Co v Richie* (1875) LR 7 HL 653

<sup>95</sup> FHI Cassim, MF Cassim & R Cassim *et al* op cit note 8 at 818. See also *McCrae v Absa Bank Limited* 2009 JDR 0782 (GSJ) at para 24

Further, persons other than the company may not find it easy in certain instances to hold directors, or any other person, liable in terms of s 218(2). It is noteworthy that a person, including a director, must have contravened a provision of the Act in order to be held personally liable to any other person in terms of s 218(2). This may lead to interpretive challenges, due to the wording of certain provisions of the Act, concerning whether there has been a contravention of a provision of the Act by a director entitling a person, other than the company, to bring an action in terms of s 218(2). For instance, Stevens and De Beer<sup>96</sup> correctly point out that in the context of a contravention of s 22(1), read with s 77(3)(b), it would be difficult for any person other than the company, to hold directors personally liable in terms of s 218(2). They argue that directors acting on behalf of the company cannot personally contravene s 22(1) because the prohibition against reckless and fraudulent trading contained in that section applies to the company itself; therefore only the company can contravene that provision.<sup>97</sup> Although s 77(3)(b) imposes liability on directors for knowingly acquiescing in the carrying on of the company's business in a manner prohibited by section 22(1), the section cannot be contravened by the directors because it is neither peremptory nor directory. And, even if it could be argued that s 77(3)(b) 'tacitly imposes on directors an implicit duty not to knowingly acquiesce to the company carrying on its business in a reckless manner,' that duty is owed to the company since the liability imposed on directors by s 77(3)(b) is to the company, and not to any other person.<sup>98</sup>

Therefore, while s 218(2) is an important provision which gives shareholders a direct remedy to recover any loss or damage from directors; the wording of certain provisions of the Act, such as s 22(1) read with s 77(3)(b) discussed above, may inhibit the ability of shareholders to hold directors personally liable in terms of s 218(2) as it may be difficult to show that the directors contravened a provision of the Act. Despite this, it is submitted that shareholders should still be able to obtain relief against directors in terms of s 20(6), even in the context of a breach of s 22(1) by the company. As noted in para 4.4.4.1 above, s 20(6) entitles a shareholder to bring a claim for damages against any person who intentionally, fraudulently or due to gross negligence causes the company to do anything inconsistent with the Act. Therefore a director who knowingly acquiesces in the carrying on of the company's business in a manner prohibited by section 22(1) would be causing the company to do

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<sup>96</sup> R Stevens and P De Beer *supra* note 40 at 274 -275

<sup>97</sup> *ibid*

<sup>98</sup> *ibid*

something inconsistent with the Act and, thereby exposes himself/herself to a shareholders' claim for damages in terms of s 20(6).

#### **4.4.4.3 Other supplementary liability provisions**

It is pertinent to note that apart from the liability in terms of s 77 as discussed above, a director may also face additional consequences as a result of remedies introduced by the new Act. For example, as a consequence of the remedy introduced by s 161 a director may find himself the subject of a court order designed to rectify any harm done to a securities holder by the director to the extent that the director is, or may be held liable in terms of s77.<sup>99</sup> The remedy afforded to securities holders in terms of s 161 will be discussed in greater detail in chapter 6. At this point it will suffice to note with regard to this remedy that s 161(1)(b)(ii) empowers a court to make '*any appropriate order*' necessary to protect any right of the security holder or to rectify any harm done to the securities holder. Therefore, the court has a wide discretion concerning the remedy that it may order.

The directors' duties in s 76, as well as the directors' liability provisions in s 77 are supplemented by s 162 of the new Act which contains an innovative remedy for a court order declaring a director delinquent or placed under probation. For instance, s 162(5)(c) provides *inter alia*, that a court must declare a director delinquent if that director *inter alia* grossly abused the position of a director, took personal advantage of information or an opportunity, contrary to the statutory fiduciary duty imposed by s 76(2)(a) or if the director acted in a manner contemplated in s 77(3)(a), (b) or (c). A consequence of a declaration of delinquency is that the person declared delinquent is automatically disqualified, and prohibited, from becoming a director of a company in terms of s 69(8) of the new Act.<sup>100</sup> A director may also be placed under probation by the court in terms of s 162(7). For instance, s 162(7)(a)(ii) provides that a court may place a person under probation if, while serving as a director, he/she acted in a manner materially inconsistent with the duties of a director. The possibility of having directors declared delinquent or placed under probation for breaching their statutory fiduciary duties is most welcome as it empowers shareholders to hold directors accountable. In *Msimang NO and another v Katuliiba and others*<sup>101</sup> the court said that the remedy of having a director declared delinquent is aimed at 'protecting companies and corporate stakeholders against directors, who have proven themselves to be unable to manage

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<sup>99</sup> See section 161(1)(b)(ii)(bb) of the new Act

<sup>100</sup> *Kukama v Lobelo* [2012] JOL 28828 (GSJ)

<sup>101</sup> *Msimang NO and another v Katuliiba* [2013] 1 All SA 580 (GSJ) at 587



the business of the company or have failed in, or are in neglect of, their duties and obligations as directors of a company.’ The remedy provided by s 162 will be more fully discussed in chapter 6. It suffices to say that s 162 has serious ramifications for directors who breach their statutory duties.

#### **4.4.5 Business judgment rule**

A discussion of directors’ liability in terms of the new Act would not be complete without mentioning the business judgment rule. The business judgment rule is a safe-harbour provision designed to shield directors from liability when they are sued for breach of their fiduciary duties and their duty to act with due care, skill and diligence. The essence of the business judgment rule as contained in s 76(4)(a)(i) to (iii) is that a director will be protected from liability for breach of his statutory duties in a particular matter if the director took reasonably diligent steps to become informed about the matter, and he or a person related to the director had no material personal financial interest; or, where such a personal financial interest existed, the director disclosed the interest as required by section 75 of the new Act. Further, the director must have made a decision, or supported the decision of a committee or the board, with regard to that matter, and the director must have had a rational basis for believing, and did believe, that the decision was in the best interests of the company.

While the inclusion of the business judgment rule in the new Act is something new, at common law the courts have not been inclined to second guessing directors’ judgments. Directors who make business judgments on an informed basis and in good faith are protected by the common law. For instance, in *Levin v Felt and Tweeds Ltd*,<sup>102</sup> the court said the following:

‘In the absence of any allegations that the directors acted mala fide this amounts to asking the court to usurp the functions of the directors and to consider what is in the best interest for the company from a business point of view ... this is not the function of a court of law ... the court is not concerned with the commercial wisdom of the scheme.’

In the case of *Fisheries Development Corporation of SA Ltd v Jorgensen*<sup>103</sup> the court said that directors are not liable for mere errors of judgment. In other words, directors who act honestly and reasonably in making business judgments are adequately protected by the common law against liability for mere errors of judgment.

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<sup>102</sup> *Levin v Felt and Tweeds Ltd* 1951 (2) SA 401 (A) at 414-415

<sup>103</sup> *Fisheries Development Corporation of SA Ltd v Jorgensen and another* supra note 7 at 166

In the light of the above it is submitted that the inclusion of the business judgment rule in the Act does not influence the balance of power between shareholders and directors. Perhaps the major benefit of including the business judgment rule in the Act is to make the law on the point more understandable to the layman.

## **4.5. Exemption from duty, indemnification and directors' insurance**

### **4.5.1 General**

The value of the statutory directors' fiduciary duties and the duty of care and skill in the new Act as a mechanism for protecting the company – and ultimately the shareholders – from directors' malfeasance depends largely on whether, and to what extent, the law allows companies to exempt their directors or indemnify them from liability for breach of those duties. This is because the potential for attracting personal liability for breach of duty acts as an incentive for directors to uphold their duties; in the absence of such potential liability some directors could be casual in the observance of their duties. However corporate law allows for the indemnification of directors from liability in certain instances. Indemnities and directors' liability insurance are tools companies have employed in some cases to exempt their directors from liability or to limit the extent of the directors' liability for breach of their fiduciary duties or the duty of care and skill.<sup>104</sup> For instance in *Re City Equitable Fire Insurance Co Ltd*<sup>105</sup> the court found the directors of the company to have acted negligently by failing to detect the fraud perpetrated on the company by its managing director. However, the directors were protected from liability by a provision in the company's constitution which exempted them from liability. It is therefore important to discuss whether, and to what extent the new Act permits the use of these tools to affect the liability of directors.

### **4.5.2 Prohibition against exemption from duty or liability**

Section 78(2) prohibits the exemption of directors from their statutory duties or from liability for breach of duty.<sup>106</sup> It provides as follows:

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<sup>104</sup> M Bekink 'Indemnification and aspects of directors' and officers' liability insurance in terms of section 78 of the Companies Act 71 of 2008' (2011) 23 *SA Merc LJ* 88

<sup>105</sup> *In re City Equitable Fire Insurance Co Ltd* supra note 29

<sup>106</sup> It must be pointed out that although the provisions of s 78 of the Companies Act apply to directors, s 78(1) provides that the term 'director' in s 78 has an extended meaning which includes prescribed officers and members of a company's board committee or audit committee.

‘Subject to subsections (4) to (6), any provision of an agreement, the Memorandum of Incorporation or rules of a company, or a resolution adopted by a company, whether express or implied, is void to the extent that it directly or indirectly purports to-

(a) relieve a director of-

(i) a duty contemplated in section 75 or 76; or

(ii) liability contemplated in section 77; or

(b) negate, limit or restrict any legal consequences arising from an act or omission that constitutes wilful misconduct or wilful breach of trust on the part of the director.’

Section 78(2) is meant to ensure that a company cannot undertake *not* to hold a director liable for breach of the statutory fiduciary duties and the duty of care and skill or, to relieve him from any liability imposed by s 77.<sup>107</sup> The section is a general prohibition against any measures designed to exempt or indemnify a director from liability for breach of their statutory fiduciary duties and the duty of care and skill or, the liability imposed by s 77. Subject to the exceptions contained in ss 78(4) to (6) relating to the indemnification of directors, the prohibition contained in s 78(2) effectively ensures that the statutory directors’ duties are mandatory. As such it is not open to companies to exempt their directors from the statutory duties as some companies were wont to do in their articles in respect of the common law directors’ duties.<sup>108</sup> The ambit of the prohibition in s 78(2) is wide. It covers provisions in the company’s constitution – the memorandum of incorporation – and the company’s rules as well as provisions of agreements and any resolutions adopted by the company.

It is important to note that the prohibition contained in s 78(2) of the new Act is not a first in South African corporate law. Section 247(1) of the old Act 61 of 1973 prohibited,

‘any provision, whether contained in the articles of a company or in any contract with a company, and whether expressed or implied, which purports to exempt any director or officer or the auditor of the company from any liability which by law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company or to indemnify him against any such liability...’

There was debate whether s 247(1) also prohibited provisions that *purported to exempt a director from his duties*.<sup>109</sup> Apparently some argued that since s 247(1) prohibited provisions that exempted ‘any director... from liability which would otherwise attach to him in respect of...breach of duty...’, the articles of the company could avoid a breach of duty by exempting

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<sup>107</sup> D Davis, F Cassim, W Geach (eds) *et al Companies and Other Business Structures in South Africa*, 2ed (2011) at 115

<sup>108</sup> P Davies *Gower and Davies’ Principles of Modern Company Law* 8ed (2008) at 589

<sup>109</sup> MS Blackman, RD Jooste & GK Everingham *et al op cit* note 15 at 8 – 354-355

the director from the duty thereby ensuring that there was no duty to breach.<sup>110</sup> In this regard s 78(2)(a)(i) and (ii) of the new Act is welcome in that it clarifies the position by prohibiting provisions that either relieve a director of his statutory duties or the liability attaching to the director for breach of those duties.

From the perspective of shareholder protection the prohibition contained in s 78(2) is welcome. The new Act invests significant powers in the board of directors and, an important tool by which such powers can be checked is by way of the fiduciary duties and the duty of care and skill. Therefore, it would be detrimental to shareholder protection if directors could be exempted from their duties or from liability for breach of those duties. It is therefore a highly contentious issue whether and, to what extent, corporate law should allow companies to indemnify their directors or take out liability insurance to shield their directors against the financial consequences of making mistakes or, being in breach of their duties, in the course of their directorial duties. The discussion that follows below continues the discussion on indemnification of directors by focusing on other provisions of the Act other than s 78(2) discussed above.

### **4.5.3 Other indemnification provisions**

#### **4.5.3.1 Indemnification for payment of fines**

The new Act prohibits a company from directly or indirectly paying any fine that may be imposed on a director of the company, or a director of a related company, as a consequence of that director having been convicted of an offence, unless the conviction was based on strict liability.<sup>111</sup> This prohibition is commendable. It would be contrary to principles of good corporate governance, and also undesirable that a company should pay a fine imposed on director convicted of an offence, for example, in terms of the Prevention and Combating of Corrupt Activities Act 12 of 2004.

It seems that the prohibition is limited to fines imposed on a director *as a consequence of that director having been convicted of an offence*. Thus it would appear that the prohibition does not apply to administrative fines<sup>112</sup> imposed upon directors. If this is the

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<sup>110</sup> *ibid*

<sup>111</sup> Section 78(3) of the Companies 71 of 2008.

<sup>112</sup> Section 171(7)(a) of the new Act read with s 175(1) provides that 'If a person to whom a compliance notice has been issued fails to comply with the notice, the Commission or the Executive Director, as the case may be, may apply to a court for the imposition of an administrative fine.' And s 175(1) empowers a court, on application by the Commission or the Panel to impose a fine an administrative fine for failure to comply with a compliance notice as contemplated in s 171(7).

case, then the prohibition is unnecessarily narrow. It is submitted that there is no good reason why a director upon whom an administrative fine has been imposed by the court in terms of s 175(1) read with s 171(7) of the new Act for failure to comply with a compliance notice should be indemnified by the company. The prohibition against payment of fines and penalties ought to have been couched in such a way as to cover administrative fines imposed by regulatory authorities such as the Commission.

It must also be noted that there is an exception to the prohibition; it does not apply to a private company or a personal liability company if a single individual is the sole shareholder and sole director of that company, or if two or more related individuals are the only shareholders of that company, and there are no directors of the company other than one or more of those individuals.<sup>113</sup> It is submitted that this is a sensible and unproblematic exception because it relates to companies that are closely held and where ownership and control of the company resides in one or more related individuals. The same people who wield the power as directors of the company are also the shareholders of the company. Therefore, the agency problem – and hence shareholder protection issues – are unlikely to arise in such companies as there is no separation of ownership and control.

To wind up this discussion concerning the indemnification of directors for fines imposed on a director for an offence in terms of the Act, it is pertinent to note that one of the objectives of the company law reform process was that ‘company law sanctions should be decriminalized where possible.’<sup>114</sup> Pursuant to this objective a notable feature of the new Act is that, ‘while certain forms of conduct continue to carry a criminal sanction – such as falsification of records, publication of untrue or misleading statements and refusal to respond to a summons – the Act has largely moved away from criminal to administrative remedies.’<sup>115</sup> Hence directors face fewer criminal sanctions under the new Act than they would have faced under the old Act.<sup>116</sup> While this could be seen as yet another instance of the new Act favouring directors, the move is understandable. The new Act is a business legislative instrument whose purposes include encouraging entrepreneurship,<sup>117</sup> promoting

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<sup>113</sup> Section 78(3A) of the new Act

<sup>114</sup> Paragraph 1.2.5 (a) of the Memorandum on the objects of the Companies Bill 2008 [B61 – 2008] (published in GG 31104 of 30 May 2008)

<sup>115</sup> Dennis Davis, Walter Geach, Tshepo Mongalo *et al Companies and Other Business Structures in South Africa* 3ed (2013) at 21

<sup>116</sup> Dorothy Farisani ‘The potency of co-ordination of enforcement functions by the new and revamped regulatory authorities under the new Companies Act’ in Tshepo Mongalo (ed) *Modern Company Law for a Competitive South African Economy* 433 at 433-434

<sup>117</sup> Section 7(b)(i) of the new Act

innovation and investment in South African markets<sup>118</sup> and reaffirming the concept of the company as a means of achieving economic and social benefits.<sup>119</sup> Hence it would be inappropriate to impose too many criminal offences under the new Act because then it would begin to sound more like a criminal code than a business legislative instrument and, in the process discourage the realization of its stated objectives. Instead of relying largely on criminal sanctions for its enforcement the new Act appropriately ‘provides alternative non-criminal avenues of enforcement.’<sup>120</sup>

#### **4.5.3.2 Indemnification for expenses to defend legal proceedings**

Section 78(4) relates to advances and indemnities concerning expenses associated with legal proceedings. It provides that:

- ‘Except to the extent that a company’s Memorandum of Incorporation provides otherwise, the company-
- (a) may advance expenses to a director to defend litigation in any proceedings arising out of the director’s service to the company; and
  - (b) may directly or indirectly indemnify a director for expenses contemplated in paragraph (a), irrespective of whether it has advanced those expenses, if the proceedings-
  - (i) are abandoned or exculpate the director; or
  - (ii) arise in respect of any liability for which the company may indemnify the director, in terms of subsections (5) and (6).’

It is important to note that this provision is an alterable provision in that it is made subject to what the memorandum of incorporation (MOI) says concerning such advances and indemnities.

While the fact that s 78(4) is an alterable provision provides flexibility for companies to decide whether or not they want their company to have the ability to provide such advances and indemnities, it is submitted that this scheme of things favours directors. For, the default position is that if the MOI is silent on the subject then the company may provide advances to defend legal proceedings or indemnify the director against such expenses within the prescripts of s 78(4). Moreover, in such an instance no shareholder approval is required before the company could make the advances or provide the indemnity. The implication is that shareholders who do not want their company to provide such advances or indemnities, or

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<sup>118</sup> Section 7(c) of the new Act

<sup>119</sup> Section 7(d) of the new Act

<sup>120</sup> Van Der Linde K, ‘The new Companies Act – Emerging Trends and Themes’ (2009) *Annual Banking Law Update* 178 at 187

who would want to have a say on the matter, must be pro-active in ensuring that the company's MOI contains an appropriately worded provision to that effect. Otherwise, in the absence of such a provision it will be up to the board of directors to decide whether or not the company should provide an advance or indemnify the director for the legal expenses. It would seem that the advance contemplated by s 78(4)(a) could be in the form of a loan. The view has been expressed, in relation to s 78(4), that,

‘A welcome change, however, in the new statutory provisions is that, unlike under the 1973 Act, companies may now make a loan advance to directors to allow them to meet their legal costs to defend litigation arising out of their service to the company. This will include the fees of legal counsel. Legal costs frequently involve substantial amounts of money. It is not required that the company should wait until the court has made its decision in the legal proceedings. To put it differently, while an indemnity is generally retrospective, an advance to pay legal costs is prospective’<sup>121</sup>

It is noteworthy that, s 78(4) does not expressly require that the directors approving the advance must take into account the ability of the director concerned to repay the advance.<sup>122</sup> Notwithstanding this, the shareholders do have some measure of protection in that the directors would still be bound by their statutory and common law fiduciary duties to act in good faith and in the best interests of the company as well as with due care and skill.<sup>123</sup> Our s 78(4)(a) is similar to s 8.53 of the MBCA which also permits a company to advance funds to a director to enable him/her to defend litigation in any proceedings arising out of the director's service to the company. Section 8.53 provides, *inter alia*, that:

(a) A corporation may, before final disposition of a proceeding, advance funds to pay for or reimburse the reasonable expenses incurred by an individual who is a party to the proceeding because that individual is a member of the board of directors...

Like our s 78(4), s 8.53(b) also does not require that the directors' financial ability to repay the advance be taken into account.

It is interesting to note that s 8.52 of the MBCA creates a statutory right of indemnification in favour of a director who successfully defends a legal suit to which he was a party. Section 8.52 provides as follows:

‘A corporation shall indemnify a director who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which he was a party because he was a director of the corporation against reasonable expenses incurred by him in connection with the proceeding fends the legal proceedings which he was a party to.’

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<sup>121</sup> FHI Cassim, MF Cassim & R Cassim *et al* op cit note 8 at 576

<sup>122</sup> *ibid*

<sup>123</sup> *ibid* at 577

Similarly, section 145(c) of the Delaware General Corporation Law also provides for mandatory indemnification against expenses, including attorneys' fees, actually and reasonably incurred by a director where the director has been successful on the merits or otherwise in defense of any action, suit or proceeding to which he was a party in his capacity as a director. This mandatory indemnification contrasts sharply with the voluntary nature of the indemnification contemplated in our s 78(4)(b)(i). In this respect s 8.52 of the MBCA and s 145(c) of the Delaware General Corporation Law are more favourable to directors than our s 78(4)(b)(i).

#### **4.5.3.3 Indemnification for other liability**

Other significant provisions in the new Companies Act concerning the indemnification of directors are ss 78(5) and (6) which provide as follows:

- ‘(5) Except to the extent that the Memorandum of Incorporation of a company provides otherwise, a company may indemnify a director in respect of any liability arising other than as contemplated in subsection (6).
- (6) A company may not indemnify a director in respect of-
  - (a) any liability arising-
    - (i) in terms of section 77(3)(a), (b) or (c); or
    - (ii) from wilful misconduct or wilful breach of trust on the part of the director...

Section 78(5) is an alterable provision since it provides that, *‘Except to the extent that the MOI provides otherwise, a company may indemnify a director in respect of any liability...’* Arguably this provides flexibility for companies to decide whether or not they want to indemnify their directors against any liability. Notwithstanding this it must be noted that the default position provided for in s 78(5) is framed in very wide terms. It enables a company to indemnify a director in respect of *any* liability except that which is referred to in s 78(6). Section 78(6)(a)(i) prohibits the company from indemnifying its director in respect of his/her liability arising in terms of s 77(3)(a), (b) or (c). Sections 77(3)(a), (b) and (c) provide that:

- A director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having-
  - (a) acted in the name of the company, signed anything on behalf of the company, or purported to bind the company or authorise the taking of any action by or on behalf of the company, despite knowing that the director lacked the authority to do so;
  - (b) acquiesced in the carrying on of the company’s business despite knowing that it was being conducted in a manner prohibited by section 22(1);



(c) been a party to an act or omission by the company despite knowing that the act or omission was calculated to defraud a creditor, employee or shareholder of the company, or had another fraudulent purpose;

Section 78(6)(a)(ii) prohibits a company from indemnifying its director from liability for willful misconduct or wilful breach of trust on the part of the director.

Therefore apart from the exceptions listed in s 78(6), it would appear that in the absence of any provision in a company's MOI to the contrary, a company is free to indemnify its directors in terms of s 78(5) against *any* liability incurred by the director in the performance of his duties towards the company, including instances where the director acted negligently. This default position in the new Act is wider than the indemnity that was allowed in terms of s 247(2) of the old Companies Act. There a company could indemnify its director in respect of, amongst other things, any liability incurred by him in defending any proceedings in which judgment was given in his favour or in which he was acquitted or in respect of any such proceedings that were abandoned. The wide ambit of s 78(5) of the new Act means that there is now greater scope for companies to indemnify their directors against any liability, not just liability incurred in defending legal proceedings. It must be noted that indemnification for expenses incurred in defending legal proceedings only applies if the legal proceedings are abandoned or exculpate the director in terms of s 78(4)(b)(i) as noted in paragraph 4.5.3.2 above.

#### **4.5.4 Directors' liability insurance**

##### **4.5.4.1 Directors' liability insurance: section 78(7) of the Companies Act 71 of 2008**

The issue whether, and to what extent a company should provide liability insurance for its directors is a highly contentious subject.<sup>124</sup> The approach of the new Companies Act on the subject is encapsulated in ss 78(7)(a) and (b) which provides that,

Except to the extent that the company's MOI provides otherwise, a company may purchase insurance to protect –

(a) a director against any liability or expenses for which the company is permitted to indemnify a director in accordance with subsection (5); or

(b) the company against any contingency including, but not limited to -

(i) any expenses-

(aa) that the company is permitted to advance in accordance with subsection (4)(a); or

(bb) for which the company is permitted to indemnify a director in accordance with subsection (4)(b); or

(ii) any liability for which the company is permitted to indemnify a director in

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<sup>124</sup> See the discussion that follows below in para 4.5.4.2

accordance with subsection (5).

Related provisions are ss 78(5) and (6) which provide as follows:

(5) Except to the extent that the Memorandum of Incorporation of a company provides otherwise, a company may indemnify a director in respect of any liability arising other than as contemplated in subsection (6).

(6) A company may not indemnify a director in respect of-

(a) any liability arising-

(i) in terms of section 77(3)(a), (b) or (c); or

(ii) from wilful misconduct or wilful breach of trust on the part of the director; or

(b) any fine contemplated in subsection (3).

It is important to note that a 78(7) does not permit insurance cover against *all* liability. Rather it allows cover against any liability or, expenses which the company is permitted to advance to a director or, for which the company is allowed to indemnify a director as provided in terms ss 78(4)&(5).

Section 78(7) is an alterable provision to the extent that it makes the company's ability to purchase insurance subject to what is provided in the company's MOI. Thus section 78(7) provides flexibility; a company may elect not to purchase insurance to protect its directors from liability by inserting an appropriately worded provision in its MOI. This flexibility is important because, there are persuasive arguments both for and against giving a company the ability to purchase directors' liability insurance. A key argument against the provision of directors' liability insurance is that indemnifying directors against the consequences of breach of their duties effectively takes away the protection offered to shareholders by the directors' duties; that is, protecting directors against the financial consequences of their negligent conduct drastically reduces the incentive for directors to take care in their conduct of the company's affairs.<sup>125</sup> On the other hand the duties imposed by the law on directors places them at risk of being held personally liable for losses suffered by the company as well as third parties in certain instances.<sup>126</sup> This may deter talented individuals from taking up directorships. Hence it has been argued that to encourage skilled people to take up directorships as well as to encourage such individuals to take informed and rational risks, companies should be given some latitude in protecting themselves and their directors against liability through insurance.<sup>127</sup>

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<sup>125</sup> D Botha and R Jooste op cit note 31 at 69-71

<sup>126</sup> For instance, s 218(2) of the new Act provides that any person who contravenes any provision of this Act is liable to any other person for any loss or damage suffered by that person as a result of the contravention.

<sup>127</sup> See for instance Deloitte *The new Companies Act: responsibilities of directors vs the role of the regulator* (March 2013) Available at <http://deloitteblog.co.za/wp-content/uploads/2013/04/The-new-Companies-Act-and->

In the light of the above it is crucial that shareholders be given the opportunity to decide what is good for their company – and ultimately themselves. Given the flexibility provided by s 78(7), shareholders who are opposed to the idea of their company having the ability to take out directors' liability insurance could, on the face of it, always insert a provision in their company's MOI prohibiting the company from doing so. This is provided that the reluctant shareholders have sufficient voting power to amend the company's MOI.

The scope of the insurance cover that may be provided in terms of s78(7) of the new Act is wider than the cover that could be provided in terms of the proviso to s 247 of the old Act. In terms of the latter a company was allowed to take out insurance 'as indemnification against any liability of any director or officer towards the company in respect of any negligence, default, breach of duty or breach of trust.'<sup>128</sup> Thus the liability that could be covered was liability towards the company.

On the other hand, s78(7) read with s 78(5) of the new Act permits the company to purchase insurance to protect a director against *any liability*. It would therefore appear that the new Act permits insurance not only against liability to the company but also against liability to third parties.

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[the-responsibility-of-directors.pdf](#), accessed 5 May 2014. See also the UK Department of Trade and Industry *White Paper on Company Law Reform* (March 2005) at page 23 - 24. Available at <https://www.treasure.org/ACTmedia/file13958.pdf> accessed 29 April 2014.

<sup>128</sup> Proviso to s 247(1) of the Companies Act 61 of 1973

## CHAPTER 5: REMEDIES - THE DERIVATIVE ACTION AND THE OPPRESSION REMEDY

### 5.1 Introduction

The statutory directors' duties discussed in the previous chapter would be ineffective as a tool for constraining abuse of directors' powers without any enforcement. At the same time enforcement that successfully produces the desired results calls for the law to prescribe straightforward, well-defined and readily available remedies accompanied by uncomplicated enforcement procedures.<sup>1</sup> The new Act has introduced new remedies such as a shareholder's right to seek a declaratory order concerning his/her rights under the Act or in terms of the company's MOI and, an order to protect his rights in terms of s 161. Other remedies include the application to have a director declared delinquent or placed under probation in terms of 162, and the dissenting shareholder's appraisal remedy in terms of s 164. The new Act also amended some pre-existing remedies, such as the remedy against oppressive or prejudicial conduct in terms of s 163 and the statutory derivative action in terms of s 165. A discussion of these remedies is merited because the remedies are essential for holding directors accountable and therefore have a bearing on the balance of power in the company.

### 5.2.0 Remedies in the new Companies Act

#### 5.2.1 The derivative action - general

The statutory derivative action constitutes one of the key remedies available to shareholders in terms of the new Act. It is by no means a novel remedy in South African corporate law. Prior to the new Act coming into force the remedy existed at common law<sup>2</sup> as well as in statute.<sup>3</sup> The common law derivative action has been abolished by s 165(1) of the new Act.

Generally the derivative action is a remedial device<sup>4</sup> that enables a person, including a shareholder, to bring an action on behalf of the company where harm has been caused to the company but where those who are in control of the company use their control to prevent the company from taking legal action against the wrongdoer. An example would be where the

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<sup>1</sup> R Kraakman, J Armour, P Davies *et al* *The Anatomy of Corporate Law: A Comparative and Functional Approach* 2 ed (2009) 45

<sup>2</sup> *TWK Agriculture Ltd v NCT Forestry Co-Operative Ltd & others* [2006] JOL 17128 (N); 2006 (6) SA 20 (N)

<sup>3</sup> Section 266 of the old Act.

<sup>4</sup> MS Blackman, RD Jooste & GK Everingham *et al* *Commentary on the Companies Act* (2002) Volume 2 at 9 – 178

directors themselves cause harm to the company.<sup>5</sup> In such circumstances it is unlikely that the directors acting on behalf of the company would commence action against the malfeasant directors if the latter controlled the majority of the votes at a meeting of the board. Hence corporate law fashioned the derivative action as an answer to such a scenario. The term ‘derivative action’ connotes the fact that the person who brings the action on behalf of the company derives the *locus standi* to bring the action from the company which suffered the harm.<sup>6</sup>

The principles associated with the derivative action were laid down in the old English case of *Foss v Harbottle*.<sup>7</sup> One of those principles is that where harm is caused to the company or, where money or damages are due to the company, the proper plaintiff to bring legal action is none other than the company itself – this is the proper plaintiff rule.<sup>8</sup> The proper plaintiff rule operated in tandem with the internal management rule. The essence of the internal management rule was that where the alleged wrong was a transaction that could be made binding on the corporation and on all its members by a simple majority of the members, no individual member of the corporation could bring an action in respect of that matter because the majority could confirm the transaction, thereby bringing the matter to an end.<sup>9</sup> Simply stated the internal management rule meant that the courts would not interfere in the internal management of companies acting within their powers.<sup>10</sup>

The principles discussed above were commonly referred to as the rule in *Foss v Harbottle*<sup>11</sup>. There were exceptions to the rule in *Foss v Harbottle* whereby, despite the rule, a minority shareholder was allowed to bring an action on behalf of the company in certain circumstances.<sup>12</sup> Some of these exceptions were stated in *Prudential Assurance Co Ltd v Newman Industries Ltd and Others*<sup>13</sup> where the court stated that the rule found no application in the following circumstances:

- Where the alleged wrong was *ultra vires* the corporation, because the majority of members could not confirm the transaction.

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<sup>5</sup> J T Pretorius, P A Delpont, M Havenga and M Vermaas *Hahlo's South African Company Law through the Cases* 6 ed (1999) 382

<sup>6</sup> FHI Cassim, MF Cassim, R Cassim *et al Contemporary Company Law* 2ed (2012) 775

<sup>7</sup> *Foss v Harbottle* (1843) 2 Hare 461

<sup>8</sup> *ibid*; See also *Mozley v Alston* (1847) 1 Ph 790

<sup>9</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd and Others (No 2)* [1982] CH 204 at 210 F – 211 A

<sup>10</sup> HS Cilliers, ML Benade, JJ Henning *et al Cilliers & Benade Corporate Law* 3 ed (2000) 296.

<sup>11</sup> *Roestof NO and another v Johns* [2012] JOL 29255 (KZD) at 5

<sup>12</sup> *McLelland v Hulett and Others* 1992 (1) SA 456 (D) at 467B-H

<sup>13</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd and Others (No 2)* *supra* note 9 at 210 F – 211 A

- Where the transaction complained of could be validly done or sanctioned only by a special resolution or the like, because a simple majority could not confirm a transaction which required the concurrence of a greater majority.
- Where what had been done amounted to fraud and the wrongdoers were themselves in control of the company. In this case the rule was relaxed in favour of the aggrieved minority, who were allowed to bring a minority shareholders' action on behalf of themselves and all others. The reason for this was that, if they were denied that right, their grievance could never reach the court because the wrongdoers themselves, being in control, would not allow the company to sue.

Outside of these exceptions, the effectiveness of the common law derivative action was greatly limited by the rule in *Foss v Harbottle* as discussed above. This led the Van Wyk de Vries Commission to recommend the establishment of a statutory derivative action.<sup>14</sup> The commission's recommendation culminated in the enactment of the statutory derivative action in the form of s 266 of the old Act. The common law action was however retained and the two actions existed side by side.

In terms of s 266(1) of the old Act the derivative action could be brought on behalf of the company in situations where the company had suffered damages or loss or had been deprived of any benefit as a result of any wrong, breach of trust or breach of faith committed by any director or officer of that company or by any past director or officer while he was a director or officer of that company and the company had not instituted proceedings for the recovery of such damages, loss or benefit. Further, section 266(1) also provided that, amongst other things, the statutory derivative action could be brought notwithstanding that the company had in any way ratified or condoned any such wrong, breach of trust or breach of faith or any act or omission relating thereto. Accordingly, the fact that the wrong complained of was capable of being ratified by a simple majority vote was no bar to the derivative action in terms of s 266(1) of the old Act. On this count the statutory derivative action in the old Act was an improvement on the common law derivative action to the extent that the application of the rule in *Foss v Harbottle* – the internal management rule in particular – was blunted by s 266(1).

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<sup>14</sup> *Commission of Enquiry into the Companies Act*, Main Report RP 45/1970 para 42,10-18

Further, the statutory derivative action could only be brought if a company had sustained damages or loss, or if it had been deprived of any benefit “*as a result of any wrong, breach of trust or breach of faith committed by any director or officer of that company or by any past director or officer...of that company.*”<sup>15</sup> In this respect the statutory derivative action in s 266(1) of the old Act was wider in ambit than the common law action in the sense that potential defendants in terms of the statutory action included not only serving directors, but also past directors and officers of the company. Moreover, the only requirement for the availability of the derivative action in terms of s 266(1) was that the company must have suffered loss irrespective of whether or not the wrongdoers had profited at the company’s expense. By contrast at common law the defendants needed to have profited at the company’s expense for the action to be available.<sup>16</sup>

In certain respects the statutory derivative action in terms of s 266(1) of the old Act was narrower in ambit than the common law action. It was narrower in that it could not be resorted to where the general meeting could not function.<sup>17</sup> In contrast the common law action was available where, for example, owing to the exigency of a case, it was not practical to convene a general meeting of the members in time for them to make a decision on a matter affecting the company.<sup>18</sup> The statutory action was also narrower because it was only available against wrongdoing directors and officers, or past directors and officers of the company<sup>19</sup> whereas the common law action was also available where the company’s action was against the majority of its members.<sup>20</sup>

### **5.2.2 The statutory derivative action – section 165 of the new Act**

The new Act not only repealed the old Act, but it also abolished<sup>21</sup> the common law derivative action and substituted it with the statutory derivative action which is provided for in s 165(2) of the new Act. It is noteworthy that the derivative action in terms of s 165(2) is not only

<sup>15</sup> Section 266(1) of the old Act. L Coetzee ‘A comparative analysis of the derivative litigation proceedings under the Companies 61 of 1973 and the Companies Act 61 of 2008’ (2010) *Acta Juridica* 290 at 295

<sup>16</sup> MS Blackman, RD Jooste, GK Everingham *et al* note 4 at 9 – 178

<sup>17</sup> *Ibid* at 9 – 177

<sup>18</sup> In *Hodgson v N.A.L.G.O.* [1972] 1 All ER 15 The court said that, ‘*Foss v Harbottle* should not be applied if the result may be to deprive the majority of an opportunity of carrying out their will. In other words, if the constitutional machinery of the body cannot operate in time to be of practical effect, the court, in my view, should entertain the suit of a member or members not supported by the association itself.’ In this case the court allowed an individual member to bring an interdict on behalf of a Union because on the facts of the case not allowing the suit brought by the member would have deprived the majority of an opportunity to express its view on the matter that was in issue. The general meeting would only have managed to meet after the relevant event had passed.

<sup>19</sup> Section 266(1) of the old Act

<sup>20</sup> *Ibid* at 9-177 to 9-178

<sup>21</sup> Section 165(1) of the new Act

available to shareholders, but also to other stakeholders namely, a director or prescribed officer of the company or a related company, a registered trade union that represents employees of the company, a representative of employees of the company and a person who has been granted leave of the court to bring the action where the court is satisfied that it is necessary or expedient to do so to protect a legal right of that person. This contrasts with s 266(1) of the old Act whereby the statutory derivative action could be brought on behalf of the company only by *a member/ shareholder of the company*.

A person intending to bring a derivative action in terms of s 165(2) of the new Act is required to first serve a demand upon a company asking the company to commence or continue legal proceedings, or take related steps, to protect the 'legal interests' of the company. No definition is provided in the new Act of the term 'legal interests' of the company. However the term encompasses, but is much wider, than the concept of 'legal rights'.<sup>22</sup> It has been observed that the term 'legal interests' can be broadly interpreted; 'interest' has been defined as 'a mere concern, involvement or investment, which could be of a financial, legal, employment or even an environmental nature.'<sup>23</sup> Therefore the derivative action in terms of s 165(2) of the new Act has a broader ambit of application than the derivative action under s 266(1) of the old Act because the latter action was only available where the company had suffered damages or losses or had been deprived of any benefit as a result of a wrong, breach of trust or breach of faith committed by a current or past director or officer of the company. Under the new dispensation a company need not have suffered damages or loss before the derivative action becomes available.<sup>24</sup>

Notably the derivative action in s 165 is exercisable against third parties, and not just directors or officers of the company as was the case under the old Act.<sup>25</sup> To the extent that the derivative action is available to protect the interests of the company, and not just in cases of breach of duty by directors, the new Act has brought the scope of the South African derivative action in line with the American and Australian models<sup>26</sup> thus realising the policy goal of modernising South African company law and bringing it in line with international best practices.<sup>27</sup> The extension of the scope of the derivative action to cover third parties is

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<sup>22</sup> P Delport *The New Companies Act Manual* 2ed (2011) 161.

<sup>23</sup> C Stein & G Everingham *The New Companies Act Unlocked* op cit note 25 at 371

<sup>24</sup> *ibid*

<sup>25</sup> H Stoop 'The derivative action provisions in the Companies Act 71 of 2008' (2012) 129 *SALJ* 527 at 535-536

<sup>26</sup> *ibid*

<sup>27</sup> See Department of Trade and Industry Policy Paper *South African Company Law for the 21<sup>st</sup> Century*. (GN 1183 published in GG 26493 of 23 June 2004)



crucial. Sometimes a company is harmed by third parties who are connected with the company's directors and, the directors would then use their control of the company to ensure action is not taken against the third parties. In such an instance the derivative action enables shareholders to by-pass the directors – who are invested with the power to make the decision whether or not to litigate – and ensure that the company's interests are protected.

### **5.2.3. Some procedural aspects and concerns**

#### **5.2.3.1 The demand requirement**

Some procedural aspects regarding the derivative action in s 165 are of concern from a shareholder protection perspective. These include the demand requirement<sup>28</sup> whereby the person desiring to bring derivative proceedings is required to 'serve a demand upon a company to commence or to continue legal proceedings, or take related steps to protect the legal interests of the company...'<sup>29</sup> In *Mouritzen v Greystone Enterprises and Another*<sup>30</sup> the court held that the service of a demand on the company is an essential prerequisite for the institution of an application under s 165(5) without which the applicant is obviously barred from launching the application.

An applicant can circumvent the demand requirement in exceptional circumstances and with the leave of the court.<sup>31</sup> Some of the exceptional circumstances listed in s 165(6)(a) and (b) include the fact that the delay occasioned by the demand requirement and other related procedures may result in irreparable harm to the company or substantial prejudice to the interests of the applicant or another person, and that there is a reasonable probability that the company may not act to prevent that harm or prejudice.<sup>32</sup>

The demand requirement in s 165(2) is not new; an equivalent requirement – though worded differently – was contained in s 266(2)(a) of the old Act. A comparison with the derivative action procedures in foreign jurisdictions also shows that the demand requirement is not unique to South Africa. In the USA a shareholder is generally required to make a demand on the board of directors to bring an action against a wrongdoing director before commencing a derivative suit.<sup>33</sup> The requirement is a corollary of the principle that where the

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<sup>28</sup> Section 165(2) of the new Act

<sup>29</sup> Section 165(2) of the new Act

<sup>30</sup> *Mouritzen v Greystone Enterprises and Another* 2012 (5) SA 74 (KZD)

<sup>31</sup> Section 165(6) of the new Act

<sup>32</sup> See section 165(6)(a) and (b) of the new Act

<sup>33</sup> KA. Goehre 'Is the demand requirement obsolete? How the United Kingdom modernised its shareholder derivative procedure and what the United States can learn from it' (2010) 28 *Wisconsin International LJ* 140 at

company has suffered harm the company itself is the proper plaintiff and, the board of directors is the organ that acts on behalf of the company and therefore has the discretion to decide whether legal action must be instituted by the company.<sup>34</sup>

Logically the demand requirement in s 165(2) of the new Act could be viewed as a tool for establishing a balance between the board's autonomy to manage the company without interference and, on the other hand, the shareholders' need to assert the company's rights.<sup>35</sup> It can also be seen as a procedural safeguard against the abuse of the derivative action.<sup>36</sup> However it has also been said of the demand requirement in the USA that it is 'a significant encumbrance to shareholder derivative litigation.'<sup>37</sup> In this regard Goehre observes that:<sup>38</sup>

'At the heart of the criticisms against the demand requirement are questions concerning transparency, fairness, and justice. Shareholder derivative procedure debatably involves an inherent conflict of interest that could potentially allow the board of directors to block litigation against one of its members. The effect of these management friendly rules "is to make individual access on behalf of the company to the courts extremely difficult." A corollary of this is that there may be less litigation than the interests of companies require. Thus, due to the obscure complexities and a lack of transparency, some argue that shareholder derivative procedure may effectively provide greater deference to the board of directors than it provides protection to the corporation and its shareholders. Moreover, the business judgment rule in the United States may make it even less likely that the directors would voluntarily choose to prosecute a claim against one of their fellow board members, knowing that a court will defer to their judgment in many cases.'

The new Act provides that a company upon which a demand has been served in terms of s 165(2) may, within 15 business days, apply to a court for the demand to be set aside on the grounds that it is frivolous, vexatious or without merit.<sup>39</sup> Failing this or, if the court does not set aside the demand, the company is obliged to appoint an independent and impartial person or, committee to investigate the demand and report to the board concerning inter alia, the probable cost of the suit and whether it appears to be in the best interests of the company to

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141. Although each state in the USA enacts its own laws most states have based their corporate law on the Model Business Corporation Act 2002 (MBCA) as well as the Delaware Corporations Code. The demand requirement is provided for in s 7.42 of the MBCA as well as in Rule 23.1(b)(3) of the Federal Rules of Civil Procedure.

<sup>34</sup> KA. Goehre op cit note 33

<sup>35</sup> H Stoop op cit note 25 at 535

<sup>36</sup> MF Cassim 'Costs orders, obstacles and barriers to the derivative action under section 165 of the Companies Act 71 of 2008 (Part 1)' op cit note 37 at 6

<sup>37</sup> KA. Goehre op cit note 33 at 146

<sup>38</sup> Ibid

<sup>39</sup> Section 165(3) of the new Act

institute proceedings.<sup>40</sup> The company has 60 business days, or a longer period which may be allowed by the court upon application, after being served with the demand, to either institute proceedings or take related steps to protect the company's interests or to serve a notice of refusal to comply with the demand upon the person who made the demand.<sup>41</sup>

The person who served the demand on the company may apply to a court for leave to bring or continue an action in the name of, or on behalf of the company and the court may grant leave only if the company fails to take any particular step required in s 165(4) discussed above, or if the company does any of the things specified in s 165(5)(a)(ii) to (iv).<sup>42</sup> Further, the court may only grant leave if it is satisfied that:

- (i) the applicant is acting in good faith
- (ii) the proposed or continuing proceedings involve the trial of a serious question of material consequence to the company, and
- (iii) it is in the best interests of the company that the applicant be granted leave to commence the proceedings or continue the proceedings as the case may be.<sup>43</sup>

It is submitted that the demand requirement and the related procedural and substantive requirements has the effect of prolonging the derivative proceedings and possibly increasing the costs to the company; all this, in an attempt to maintain the supremacy of the board in deciding on legal claims belonging to the company.<sup>44</sup> There is concern that the mere making of a demand which may, on the face of it, appear to have some merit would force the company to spend valuable time and effort dealing with the demand at its own cost.<sup>45</sup> Another concern is that the demand requirement may generate negative publicity which may be detrimental to the directors and the company alleged to have done wrong and, the company's business could be severely destabilised.<sup>46</sup> It is submitted that there are other alternative derivative action models that South Africa could have followed which do not involve a demand requirement. For instance, Canada and Australia follow a somewhat

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<sup>40</sup> Section 165(4)(a) of the new Act

<sup>41</sup> Section 165(4)(b) of the new Act

<sup>42</sup> Section 165(5)(a)(ii) – (iv) of the new Act details some circumstances in which the court may grant leave because the company has done something that does not show a serious intent to deal with the demand such as, for example, if the company appointed an investigator who was not independent or impartial or, if the company accepted a report that was irrational or unreasonable in its conclusions.

<sup>43</sup> Section 165(5)(b)(i) to (iii) of the new Act

<sup>44</sup> *Am. Int'l Group v Greenberg*, 965 A.2d 763, 808 (Del. Ch. 2009)

<sup>45</sup> C Stein & G Everingham op cit note 23 at 373

<sup>46</sup> *ibid*

different approach; legislation in both countries prescribes similar leave and notice requirements,<sup>47</sup> rather than a demand requirement.

For example, s 239(1) of the Canada Business Corporations Act (R.S.C., 1985, c. C-44) provides as follows:

‘239. (1) Subject to subsection (2), a complainant may apply to a court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.’

The preconditions to bringing a derivative suit in Canada are stated in s 239(2) which provides that;

‘(2) No action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that

- (a) the complainant has given notice to the directors of the corporation or its subsidiary of the complainant’s intention to apply to the court under subsection (1) not less than fourteen days before bringing the application, or as otherwise ordered by the court, if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action;
- (b) the complainant is acting in good faith; and
- (c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.’

The United Kingdom’s Companies Act of 2006 [hereafter ‘the UK Companies Act’] is also an example of a derivative action model that does not require that a demand be made prior to bringing a derivative suit. Section 261 of the UK Companies Act provides as follows:

‘(1) A member of a company who brings a derivative claim under this Chapter must apply to the court for permission (in Northern Ireland, leave) to continue it.

(2) If it appears to the court that the application and the evidence filed by the applicant in support of it do not disclose a prima facie case for giving permission (or leave), the court—

- (a) must dismiss the application, and
- (b) may make any consequential order it considers appropriate.

(3) If the application is not dismissed under subsection (2), the court—

- (a) may give directions as to the evidence to be provided by the company, and
- (b) may adjourn the proceedings to enable the evidence to be obtained.

(4) On hearing the application, the court may—

- (a) give permission (or leave) to continue the claim on such terms as it thinks fit,

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<sup>47</sup> See M Hoffman (2005) ‘The statutory derivative action in Australia: an empirical review of its use and effectiveness in Australia in comparison to the United States, Canada and Singapore’ at 7. Available at ePublications@bond: <http://epublications.bond.edu.au/cgej/13> accessed on 24 August 2014.

- (b) refuse permission (or leave) and dismiss the claim, or
- (c) adjourn the proceedings on the application and give such directions as it thinks fit.’

The derivative action procedure in terms of s 261(2) of the UK Companies Act gives the court a significant role as a watchman to sift unsound claims from sound ones.<sup>48</sup> It is only after the court is satisfied that the applicant has made a prima facie case, in terms of s 261(2), that the company will be called upon to provide evidence in terms of s261(3)(a). Consequently, this two stage procedure enables ‘the courts to dismiss unmeritorious claims at an early stage without involving the defendants or the company.’<sup>49</sup>

It is submitted that the UK and Canadian derivative action procedures are better than the procedure provided for in the new Act to the extent that they dispense with the time consuming, and potentially cost-inflating demand requirement provided for in the latter.

While it is conceded that the new Act makes it possible for an applicant to be excused from making the demand, it must be noted that the applicant is only excused from this requirement in exceptional circumstances as discussed earlier.<sup>50</sup> Moreover the applicant has to apply to court for leave to dispense with the requirement for a demand. It is submitted that this process for excusal from the demand requirement also adds another layer to the derivative action procedure thereby prolonging the process and potentially increasing the costs for the company and the individual applicant. Effectively the demand requirement, and the related procedure for leave to be excused from the requirement, makes for a cumbersome derivative action procedure which stands in the way of shareholders seeking to protect the company’s interests.<sup>51</sup>

### ***5.2.3.2 Best interests of the company, rebuttable presumption and the business judgement rule***

Another procedural aspect of s 165 which is of concern is the requirement that the granting of leave must be in the best interests of the company.<sup>52</sup> Related to this is the rebuttable presumption that the granting of leave is not in the best interests of the company which

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<sup>48</sup> KA. Goehre op cit note 33

<sup>49</sup> UK Companies Act 2006, Explanatory Notes, para 495 available at [http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpgaen\\_20060046\\_en.pdf](http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpgaen_20060046_en.pdf) , accessed on 13 February 2015

<sup>50</sup> Section 165(6) of the new Act

<sup>51</sup> Kurt A. Goehre op cit note 33 at 147

<sup>52</sup> Section 165(5)(b)(iii) of the new Act

applies in the circumstances outlined in the new Act.<sup>53</sup> Also associated with these is the application of the business judgment rule which is integrated into the rebuttable presumption.<sup>54</sup>

The new Act provides that a court may grant leave for derivative proceedings only if it is satisfied that, amongst other things, it is in the best interests of the company that the applicant be granted leave.<sup>55</sup> Section 165(7) further provides that,

‘A rebuttable presumption that granting leave is not in the best interests of the company arises if it is established that—  
(a) the proposed or continuing proceedings are by—  
(i) the company against a third party; or  
(ii) a third party against the company;  
(b) the company has decided—  
(i) not to bring the proceedings;  
(ii) not to defend the proceedings; or  
(iii) to discontinue, settle or compromise the proceedings; and  
(c) all of the directors who participated in that decision—  
(i) acted in good faith for a proper purpose;  
(ii) did not have a personal financial interest in the decision, and were not related to a person who had a personal financial interest in the decision;  
(iii) informed themselves about the subject matter of the decision to the extent they reasonably believed to be appropriate; and  
(iv) reasonably believed that the decision was in the best interests of the Company.’

The operation of the presumption entails that the applicant for leave now bears a greater burden of proof to discharge; he must present evidence cogent enough to refute the presumption if he is to succeed. Paragraph (c) above amounts to an integration into the statutory derivative action of a modified version of the business judgment rule set out in s 76(4) of the new Act.<sup>56</sup> The overall effect of s 165(7) above is to create a derivative action procedure that favors the board’s decision not to sue. If the board has chosen not to sue the rebuttable presumption hedges against interference with that decision because it is assumed that doing otherwise would not be in the best interests of the company; in other words, the directors have decided in the best interests of the company. Further the business judgment

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<sup>53</sup> Section 165(7) of the new Act

<sup>54</sup> Section 165(7)(c) of the new Act

<sup>55</sup> Section 165(5)(b)(iii) of the new Act

<sup>56</sup> P Delpont *The New Companies Act Manual* op cit note 22

rule ensures that the courts are unlikely to substitute their own decision for that of the board.<sup>57</sup>

On the face of it there are logical reasons for the inclusion of the rebuttable presumption and the business judgment rule as part of the derivative action procedure. In part their inclusion is based on the need to ensure that the board is able to run the company without undue interference.<sup>58</sup> The board is the organ legally mandated to manage the business and affairs of the company and thus shareholders should not be able to lightly arrogate to themselves the power to manage the company. In deciding whether or not to sue, the board not only takes into account the legal issues involved in the matter but it also weighs the commercial and business pros and cons of proceeding with the legal claim.<sup>59</sup> Thus the inclusion of the business judgment rule as part of the derivative action procedure is an affirmation of the long held view that boards of directors, constituted as they are by professional business people, are better placed by the courts to make commercial business decisions.<sup>60</sup> Therefore where a board has made a business decision not to sue that decision is presumed to be in the best interests of the company and the courts should not lightly interfere with the board's business decision.

Although the above constitute logical reasons for including the rebuttable presumption as part of the derivative action procedure, there is concern that the presumption is beset by weaknesses that significantly erode the effectiveness of the derivative action as a shareholder protection tool.<sup>61</sup> The major concern is that the phraseology employed in s 165(7) is such that the rebuttable presumption operates to protect directors who cause harm to the company.<sup>62</sup>

In terms of s 165(7)(a), the rebuttable presumption applies where the proceedings are between the company and a 'third party.' For the purposes of s 165(7) a person is a 'third party' if the company and that person are *not* related or inter-related.<sup>63</sup> A person is related to a company if he/she directly or indirectly controls the company in the broad sense of him being able to exercise, or control the exercise of a majority of the voting rights associated with the securities of that company, or if he has the power to control the majority of the votes of the

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<sup>57</sup> KA. Goehre op cit note 33 at 146

<sup>58</sup> See MF Cassim 'When companies are harmed by their own directors: the defects in the statutory derivative action and the cures (Part1)' (2013) 25 *SA MERC LJ* 168 at 173. See also K A. Goehre op cit note 33

<sup>59</sup> MF Cassim *ibid*.

<sup>60</sup> *Hogg v Cramphorn Ltd* [1967] Ch 254 at 268

<sup>61</sup> MF Cassim 'When companies are harmed by their own directors (Part1)' op cit note 58 at 169

<sup>62</sup> *ibid*

<sup>63</sup> Section 165(8)(a) of the new Act

board by virtue of the right to appoint or elect the members of the board.<sup>64</sup> In the case of juristic persons a company is related to its holding company and its subsidiaries; companies are interrelated if they are mutually controlled by the same person.<sup>65</sup>

It follows from the above that the rebuttable presumption that granting leave for derivative proceedings is not in the best interest of the company would not apply to proceedings between the wronged company and a related, or interrelated person since a related or interrelated person is not considered to be a third party by s 165(8)(a). As shown above the concept of related or interrelated persons with regard to a company revolves around the ability to control a company. There is greater scope for such related or interrelated persons to abuse their control of the company causing harm to the company and then using their control to prevent the company from taking legal action against them.<sup>66</sup> Therefore it is only proper, for the sake of minority shareholder protection, that the Act precludes the operation of the rebuttable presumption in situations where the company is harmed by its controllers.

Of concern however is the fact that the definition of a ‘third party’ for the purposes of s 165(7) includes directors of a company. In his capacity as such an individual director is not ‘related’ or ‘interrelated’ to a company in the sense in which those terms are defined in the new Act,<sup>67</sup> unless of course the director also happens to be in a position to control the company as discussed above, for instance as a majority shareholder. It follows that if a director is a third party in relation to a company, the rebuttable presumption that granting leave is not in the best interests of the company would arise in proceedings where it is sought to hold a director accountable for causing harm to the company. Cassim rightly observes that it is peculiar that the new Act provides for the exclusion of the presumption in the event of wrongdoing by majority shareholders, but fails to do the same in the case of directorial misconduct, and she aptly states that:<sup>68</sup>

‘This is most disturbing, as it overlooks the cardinal point that derivative actions in the vast majority of cases are brought to protect the company against its own errant directors. Under the Companies Act 61 of 1973, the statutory derivative action was devoted solely to misconduct by directors and officers. The derivative action is a vital weapon for empowering minority shareholders to monitor the board of

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<sup>64</sup> Section 2(2)(a)(ii)(aa)&(bb) of the new Act

<sup>65</sup> Section 2(1)(c) of the new Act

<sup>66</sup> See MF Cassim ‘When companies are harmed by their own directors(Part1)’ op cit note 58 at 169

<sup>67</sup> Section 2 of the new Act

<sup>68</sup> See MF Cassim ‘When companies are harmed by their own directors(Part1)’ op cit note 58 at 180



directors and to play an effective role in holding corporate management accountable for misconduct. In the key situation where directors have harmed the very company that they are bound to serve, the statutory derivative action should be more (and not less) flexible and readily available, because this is when the risk of conflicted or biased decision-making by the board is most acute. This risk cannot be overemphasised...the failure of s 165 to cater properly for wrongdoing by directors themselves creates a major predicament that could strangle the use and effectiveness of the derivative action where it is most needed.'

In *Mouritzen v Greystone Enterprises*<sup>69</sup> a South African High Court said , regarding the derivative action provision in the new Act, that, 'It appears that section 165 is a typical model of section 237 of the Australian Corporations Act of 2001...' Yet it appears that South Africa followed a completely different trajectory from the Australian model with regard to the operation of the rebuttable presumption. Although s 237(3) of the Australian Corporations Act also provides for a similar rebuttable presumption which arises in proceedings between the company and third parties, that presumption does not operate to protect directors. This is because s 237(4) of the Australian Corporations Act of 2001 defines the 'third party' as excluding a 'related party' while the latter term is defined to include directors.<sup>70</sup> Therefore, under that Act directors are not considered as 'third parties' who are covered by the protection of the presumption.

Further, the definition of 'related party,' in relation to a company, as provided for in s 228 of the Australian Corporations Act 2001 includes, not only the directors of the company, but also their spouses as well as the relatives of the directors and the directors' spouses namely, their parents and children. Thus the rebuttable presumption in the Australian Corporations Act 2001 would not protect directors, their spouses and relatives. It is submitted that the expansive definition of related parties in the Australian Corporations Act 2001 makes for a derivative action that is superior as a tool for protecting minority shareholders than the one in the new South African Companies Act.<sup>71</sup> Clearly the operation of the presumption as provided for in the Act makes for a derivative action procedure that favours management and which makes it difficult for shareholders to hold directors accountable.

### **5.3 Relief from oppressive or prejudicial conduct**

The remedy against oppressive or unfairly prejudicial conduct provided for in s 163 of the new Act is another significant shareholder protection tool which serves to *inter alia*, shield

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<sup>69</sup> *Mouritzen v Greystones Enterprises (Pty) Ltd and Another* supra note 30 at 87 para 36

<sup>70</sup> See section 228 of the Australian Corporations Act 2001

<sup>71</sup> See MF Cassim 'When companies are harmed by their own directors (Part 1)' op cit note 58 at 180

minority shareholders against oppressive or prejudicial conduct. Section 163(1) of the new Act provides as follows:

- ‘(1) A shareholder or a director of a company may apply to a court for relief if-
- (a) any act or omission of the company, or a related person, has had a result that is oppressive or unfairly prejudicial to, or that unfairly disregards the interests of, the applicant;
  - (b) the business of the company, or a related person, is being or has been carried on or conducted in a manner that is oppressive or unfairly prejudicial to, or that unfairly disregards the interests of, the applicant; or
  - (c) the powers of a director or prescribed officer of the company, or a person related to the company, are being or have been exercised in a manner that is oppressive or unfairly prejudicial to, or that unfairly disregards the interests of, the applicant.’

The remedy contained in s 163(1) of the new Act is not entirely new; its antecedent was s 252 of the old Act.<sup>72</sup> However, s 163(1) is wider than s 252 in the following respects:

- Under the old provision only a shareholder could petition for relief but under s 163(1) the remedy is also available to a director.<sup>73</sup>
- The remedy in terms of s 252 of the old Act was concerned with a particular act or omission of the company or the manner in which the affairs of the company were being conducted whereas s 163(1) of the new Act includes acts or omissions of a person related to the company or the manner in which the business of a related person is being conducted.
- Section 163(1)(c) widens the scope of the remedy by extending its application to the manner in which the powers of a director or prescribed officer of the company, or a person related to the company, are being or have been exercised.<sup>74</sup>

By extending the scope of the remedy to include related persons, s 163 (1) addresses an issue that arose in the past concerning whether, and to what extent, a shareholder of a company could bring an action complaining about the ‘conduct’ of the company’s holding company or subsidiary company.<sup>75</sup> The extension to related persons significantly limits the scope for evading the application of the provision in the context of intra-group dynamics.<sup>76</sup> Section

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<sup>72</sup> *Visser Citrus (Pty) Ltd v Goede Hoop Citrus (Pty) Ltd and Others* 2014 (5) SA 179 (WCC) at 192

<sup>73</sup> *Ibid* at 192- 193

<sup>74</sup> In terms of s 2(1) of the Companies Act 71 of 2008 the concept of a related person includes a holding a company and its subsidiaries as well as companies that are, or whose business is, mutually controlled by one person.

<sup>75</sup> FHI Cassim, MF Cassim, R Cassim *et al* op cit note 6 at 768 and the cases cited therein

<sup>76</sup> *Ibid*

252(1) of the old Act was considered ineffectual because of its narrow scope as well as its stringent requirements. The broadened scope of s 163(1) of the new Act is welcomed.<sup>77</sup>

It is also arguable that s 163(1) considerably broadens the range of acts or omissions in respect of which relief may be sought. Whereas s 252(1) of the old Act employed the key words ‘unfairly prejudicial, unjust or inequitable,’ section 163(1) of the new Act on the other hand uses the words ‘oppressive or unfairly prejudicial to, or that unfairly disregards the interests, of the applicant.’<sup>78</sup> In *Grancy Property Limited v Manala and Others*<sup>79</sup> the Supreme Court of Appeal noted that the concept of ‘interests’ is much wider than the concept of ‘rights’ and thus the inclusion of the element of unfair disregard of the applicant’s interests underscores the extensive nature of the remedy provided for by s 163.

Although section s 163 of the new Act may be wider in scope than its predecessor, there are similarities in the wording of the two sections. Hence the jurisprudence developed in relation to s252 is likely to guide the courts in construing what constitutes ‘oppressive’ or ‘unfairly prejudicial conduct’ in the context of s 163.<sup>80</sup> An examination of court decisions shows that conduct that is ‘burdensome, harsh and wrongful’ . . . or which “involves at least an element of lack of probity or fair dealing” . . . or “a visible departure from the standards of fair dealing and a violation of the conditions of fair play on which every shareholder who entrusts his money to a company is entitled to rely,” constitutes ‘oppressive conduct’ for the purposes of s 163.<sup>81</sup>

To succeed with an action against oppressive or unfairly prejudicial conduct, ‘an applicant...must establish the following: that the particular act or omission has been committed, or that the affairs of the company are being conducted in the manner alleged, and that such act or omission or conduct of the company’s affairs is unfairly prejudicial, unjust or inequitable to him or some part of the members of the company...’<sup>82</sup> In other words, the conduct departs from the accepted standards of fair play or it amounts to unfair discrimination of the minority.<sup>83</sup> In *Visser Citrus (Pty) Ltd v Goede Hoop Citrus (Pty) Ltd and*

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<sup>77</sup> C Stein and G Everingham op cit note 23 at 367

<sup>78</sup> Ibid at 368. See also *Peel & Others v J & C Hamon Engineering (Pty) Ltd & Others* 2013 (2) SA 331 (GSJ) at 352.

<sup>79</sup> *Grancy Property Limited v Manala and Others* [2013] All SA 111 (SCA) at para 26

<sup>80</sup> Ibid at para 22.

<sup>81</sup> Ibid

<sup>82</sup> *Louw v Nel* 2011 (2) SA 172 (SCA) at para 23

<sup>83</sup> *Donaldson Investments (Pty) Ltd v Anglo-Transvaal Collieries Ltd* 1979 (3) SA 713 (W) at 722

*Others*<sup>84</sup> the court noted that where the conduct complained of was unlawful and had a consequence that was prejudicial to the applicant, the prejudice to or disregard of the applicant's interests would invariably be unfair within the meaning of s 163.

The facts in *Visser Citrus (Pty) Ltd v Goede Hoop Citrus (Pty) Ltd and Others* were that the board of Goede Hoop Citrus had refused to approve a transfer by Visser Citrus (the applicant) to Mouton Citrus (the second respondent) of the shares held by Visser Citrus in Goede Hoop Citrus. Consequently Visser Citrus brought an action in terms of s 163 of the new Act seeking to compel Goede Hoop Citrus to register the transfer. One of the issues the court had to deal with was whether the directors of Goede Hoop had breached their fiduciary duties in refusing to register the transfer. In dealing with this issue the court also had to consider a related and interesting question concerning the inter-relationship between s 163 and breach of duty by directors. The court noted that if the directors exercise a power conferred on them by the company's MOI, and in so doing satisfy the standard imposed by s 76, they act lawfully.<sup>85</sup> It then considered whether in such circumstances a shareholder who is prejudiced by the decision could complain that the decision is 'unfairly prejudicial to him? The court said that,<sup>86</sup> 'such cases potentially bring the invocation of the unfair-prejudice remedy into conflict with other principles of company law, such as majority rule and that the constitutional documents of the company are the compact between shareholders and the company by which they are all bound.'

The court noted that in England it was acknowledged that the remedy could extend beyond unlawful conduct. It further noted that the principles of majority rule and the binding nature of the company's constitution remain applicable and, the courts in England are cautious in extending the remedy beyond cases of illegality. In the light of this the court said that a South African court should take the principle of majority rule and the binding nature of the company's constitution as its starting point. Further, 'the circumstances would...have to be exceptional before one could find that a board decision, taken in accordance with the standard set by s 76, has caused a shareholder prejudice which can properly be described as 'unfair' within the meaning of s 163.'<sup>87</sup> The exceptional cases envisaged by the court of unfair conduct which is not also illegal include, the 'legitimate expectation' or 'equitable

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<sup>84</sup> *Visser Citrus (Pty) Ltd v Goede Hoop Citrus (Pty) Ltd and Others* supra note 72

<sup>85</sup> In this case the board had exercised a power conferred upon it by the company's MOI to approve or refuse a registration of transfer of shares and without having to provide reasons for refusal. The court found such a power to be lawful.

<sup>86</sup> *Visser Citrus (Pty) Ltd v Goede Hoop Citrus (Pty) Ltd and Others* supra note 72 at para 57

<sup>87</sup> *ibid* at para 65

consideration' cases arising from the informal arrangements or understandings among shareholders not contained in the company's constitution.<sup>88</sup> For example shareholders could have an informal arrangement or understanding pertaining to participation in management or, concerning dividend policy or remuneration.<sup>89</sup> In this case the court found that in refusing to register the share transfer the board of Goede Hoop Sitrus had exercised its discretion in terms of a lawful provision of the company's MOI and that in so doing the board had exercised its discretion rationally and that it had acted for a proper purpose, in good faith and in the best interests of the company in compliance with s 76. The court also found that the board's refusal to register the transfer was not unfairly prejudicial to Visser Sitrus.

The view has been expressed that,<sup>90</sup> in order to avoid a conflict between s 76 and s 163, the latter provision must 'be interpreted in such a manner that excludes the element of unfairness in all cases where a board has acted lawfully.' And, because the court did not make such a conclusion in the *Visser Sitrus* case, it has been observed that, 'the door, therefore, remains open for the argument that despite complying with s 76 a decision of the board may still be subject to attack under s 163. What must a board do to protect itself in those circumstances – contravene s 76 to save itself from attack under s 163?' While this viewpoint is understandable, it is submitted that the court's decision in the *Visser Sitrus* case is sensible. It must be remembered that the court's judgment emphasized that it would only be in exceptional circumstances where the lawful action of a board could be found to be 'unfair' for the purposes of s 163. The court even noted the dearth of cases where a decision taken by independent directors in accordance with their fiduciary duties gave rise to unfair-prejudice relief.<sup>91</sup> Notwithstanding this the court said it could not rule out the possibility that such cases might notionally exist.<sup>92</sup> Therefore the court's decision wisely leaves the door open for it to intervene in appropriate cases and, to protect the legitimate expectations of minority shareholders, especially in small private companies, against the conduct of directors albeit such conduct might be lawful. It is further submitted that the perceived conflict between s 76 and s 163 may be more apparent than real. As the *Visser Sitrus* demonstrates, the court will be wary of making a finding that a board's decision is unfairly prejudicial to the interests of one or, some of the company's shareholders where the directors' have complied

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<sup>88</sup> Ibid at paras 66 and 62

<sup>89</sup> Ibid

<sup>90</sup> Pierre Le Roux and Jarryd Madon The 'rocky' road has been paved, or has it? Directors right to refuse transfer of shares *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and Others* 2014 (5) SA 179 (WCC) (2014) 547 *DE REBUS* 40 at 40-41

<sup>91</sup> *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and Others* supra note 72 at para 67

<sup>92</sup> Ibid at para 68

with their fiduciary duties in terms of s 76. Further, the dearth of cases where a decision taken by directors in compliance with their fiduciary duties has been successfully challenged using the unfair-prejudice remedy also suggests that as long as directors comply with their duties in terms of s 76 they have little to fear that their decision could be attacked under s 163. It remains to be seen under what circumstances a court would make a finding that a board's decision made in compliance with the directors' fiduciary duties is unfairly prejudicial.

Section 163(2) provides a very wide, but not exhaustive list of remedial orders that a court may make upon considering an application for relief in terms of s 163(1). In terms of s 163(2) the court may make any interim or final order it considers fit, including, *inter alia*-

- '(a) an order restraining the conduct complained of;
- (b) an order appointing a liquidator, if the company appears to be insolvent;...
- (d) an order to regulate the company's affairs by directing the company to amend its Memorandum of Incorporation or to create or amend a unanimous shareholder agreement;...
- (f) an order-
- (i) appointing directors in place of or in addition to all or any of the directors then in office; or
- (ii) declaring any person delinquent or under probation, as contemplated in section 162...';

The wide-ranging nature of the oppression remedy provides wide latitude for courts to intervene in intra-corporate affairs thus providing a flexible tool for minority shareholder protection.<sup>93</sup> It has been observed that<sup>94</sup> the orders which the court can make in terms of s 163,

"...may involve a greater degree of judicial interference in the management of the company, being orders directed at realigning the balance of power established by the constitution (such as those directing an issue or exchange of shares, or appointing directors in place of or in addition to the directors in office), or orders that actually change the rules of the company themselves ( eg an order regulating the company's affairs by amending its Memorandum of Incorporation or creating or amending a unanimous shareholder agreement)."

Although the range of orders which a court could have made in terms of s 252(3) of the old Act was open ended, just like the orders that may be made in terms of s 163, it would seem that the relief which may be ordered under the latter is wider than that which could have been

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<sup>93</sup> FHI Cassim, MF Cassim, R Cassim *et al* op cit note 6 at 774

<sup>94</sup> *ibid*

ordered under the former.<sup>95</sup> For instance, it seems that under s 252(3) it was not competent for a court to make an order appointing directors in place of or, in addition to any or all of the directors then in office.<sup>96</sup> In *Ex Parte Avondzon Trust (Edms) Bpk*<sup>97</sup> two directors applied to court in terms of s 111 *bis* of the Companies Act, 46 of 1926 – the predecessor to s 252 – for an order extending their term of office. The court dismissed the application and held, *inter alia*, that if it extended the period of office, the Court would be exercising the power of appointing directors which was not authorised by section 111 *bis*.<sup>98</sup> On the other hand, s 163(2)(f)(i) expressly empowers the court to make ‘an order appointing directors in place of or in addition to all or any of the directors then in office.’ In *Grancy Property v Manala*<sup>99</sup> the court ordered the appointment of two independent directors to the board of the company in question and it also ordered that the two directors had ‘the sole right, in their absolute discretion, to the exclusion of any other directors nominated by the shareholders of [the company], to determine whether an investigation into the affairs of [the company], in the light of the complaints made on behalf of Grancy Property Limited, is necessary and if so to conduct such an investigation.’ Hence the powers of the court in terms of s 163 are far reaching.

It is noteworthy that the wording of the oppression remedy under s 163 is similar to the oppression remedy contained in s 241 of the Canada Business Corporations Act (R.S.C., 1985, c. C-44).<sup>100</sup> It is also similar to s 248 of the Ontario Business Corporations Act which is also based on s 241 of the Canada Business Corporations Act. Hence, in terms of s 5(2) of the new Act, Canadian legislation and court decisions are significant in interpreting s 163.<sup>101</sup>

In terms of s 241(3) of the Canada Business Corporations Act, as well as s 248 of the Ontario Business Corporations Act, Canadian courts have, just like their South African counterparts under s 163(2), wide latitude in exercising their discretion concerning the type of relief they may order in the context of oppressive or unfairly prejudicial conduct. Notably one

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<sup>95</sup> HGJ Beukes and WJC Swart *Peel v Hamon J&C Engineering (Pty) Ltd*: Ignoring the result requirement of section 163(1)(a) of the Companies Act and extending the oppression remedy beyond its statutorily intended reach’ (2014) 17 *PELJ* 1691 at 1696

<sup>96</sup> *Ex Parte Avondzon Trust (Edms) Bpk* 1968 1 SA 340 (T) 342-343. See P Delport, Q Vorster, D Burdette et al *Henochsberg on the Companies Act 71 of 2008* (2011) at 572; See also HGJ Beukes and WJC Swart *op cit* note 95 at 1696

<sup>97</sup> *ibid*

<sup>98</sup> This decision has been questioned for unjustifiably limiting the court’s power. See MS Blackman, RD Jooste & GK Everingham *et al op cit* note 4 at 9 – 47 to 9 – 48

<sup>99</sup> *Grancy Property Limited v Manala and Others* *supra* note 79 at para 40

<sup>100</sup> See *Count Gotthard SA Pilati v Witfontein Game Farm (Pty) Ltd and Others* [2013] 2 All SA 190 (GNP)

<sup>101</sup> *ibid*

of the orders Canadian courts can make under the oppression remedy is an order compensating an aggrieved person.<sup>102</sup> This is equivalent to our s 163(2)(j) in terms of which the court may make ‘an order to pay compensation to an aggrieved person...’ Significantly, Canadian courts have held directors personally liable to compensate aggrieved persons in some cases.<sup>103</sup> This is noteworthy because generally when a director acts for, and on behalf of a company his action is attributed to the company.<sup>104</sup> Hence directors are generally not personally liable for the acts of the company.<sup>105</sup> It is only in exceptional circumstances where a director attracts personally liability at common law in respect of an act that he performed on behalf of the company. The exceptional circumstances include instances where the director is at fault for breaching a duty he owes to the company or, where his action is tainted with fraud, or some impropriety in which case the corporate veil is pierced and the directors’ action is attributed to him and not the company.<sup>106</sup>

In *Sidaplex-Plastic Suppliers Inc. v. Elta Group Inc*<sup>107</sup> the court noted that while the personal liability of a director in an oppression remedy situation may be founded upon piercing of the corporate veil in some cases, the issue was not so much one of piercing the corporate veil, as ‘it was a question of the overall application of s. 248(2) of the Ontario Business Corporations Act and the interplay between its various provisions.’<sup>108</sup> The court said:

‘When the power of the director is exercised in a fashion which causes an act or omission of the corporation which effects an unfairly prejudicial result, or a result which unfairly disregards the interests of the complainant -- or which causes the business or affairs of the corporation to be conducted in a manner which has the same effect -- those powers themselves have been "exercised in a manner" which is caught by the section, in my opinion. Liability therefore lies directly with the director, under the section, in appropriate cases.

The court went on to make an order directing the director of Elta to personally pay an amount of \$97,076.36 to the aggrieved party.

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<sup>102</sup> Section 241(3)(j) of the Canada Business Corporations Act (R.S.C., 1985, c. C-44) ; See also s 248(3)(j) of the Ontario Business Corporations Act, R.S.O. 1990, c. B.16

<sup>103</sup> *Budd v. Gentra Inc.* (1998) 43 BLR (2d) 27 (Ont CA)

<sup>104</sup> *Barkett v SA Mutual Trust & Assurance Co Ltd* 1951 (2) SA 353 at 362; HS Cilliers, ML Benade, JJ Henning *et al* op cit note 10

<sup>105</sup> *Salomon v Salomon and Co Ltd* [1897] AC 22 (HL); *Airport Cold Storage (Pty) Ltd v Ebrahim* 2008 (2) SA 303(C)

<sup>106</sup> *Airport Cold Storage (Pty) Ltd v Ebrahim* supra note 105

<sup>107</sup> *Sidaplex-Plastic Suppliers Inc. v. The Elta Group Inc , Frank Lin and Kimoto Canada Inc.* (1995) 131 D.L.R. (4<sup>th</sup>) 399 at 405-407

<sup>108</sup> *ibid*



In *Budd v Gentra*<sup>109</sup> the trial court dismissed an action brought under the oppression provisions in s 241 of the Canada Business Corporations Act on the basis that, *inter alia*, directors and officers could only be held personally liable to compensate an aggrieved party under s. 241 of the Canada Business Corporations Act where personal liability would attach in accordance with the common law principles. These principles were that ‘in the absence of fraud, deceit, dishonesty or want of authority on the part of a director, the director could not be held personally liable unless it could be shown that their actions are themselves tortious or exhibit a separate identity or interest from that of the company so as to make the act or conduct complained of their own.’<sup>110</sup>

The Ontario Court of Appeal rejected the reasoning of the trial court in *Budd v Gentra*. It held that the case for holding a director personally liable in an oppression case under s 241 of the Canada Business Corporations Act was fundamentally different from those cases where directors are held personally liable under the common law. It said that in oppression cases ‘the plaintiff is not alleging that he was wronged by a director or officers acting in his or her personal capacity, but is asserting that the corporation, through the actions of the directors or officers, has acted oppressively and that in the circumstances it is appropriate (i.e. fit) to rectify that oppression by an order against the directors or officers personally.’<sup>111</sup> The court noted that,<sup>112</sup>

‘to the extent that s 241 of the Canada Business Corporations Act contemplates that individuals will bear the remedial burden flowing from the oppressive exercise of corporate powers, it [s. 241] takes a different approach to assigning responsibility for corporate conduct than does the common law. The section permits the court to address the harm done by the conduct described in s. 241 from a broader perspective than that permitted by a simple inquiry into the true identity of the actor.’

It went on to caution against overlaying the restrictive common law principles on the broad statutory language of s 241.<sup>113</sup>

The court noted that there were two criteria to be considered in deciding whether an oppression action claiming a monetary order reveals a reasonable cause of action against directors personally. First, there must be an act or omission ‘by the director that is directly linked to the conduct said to constitute the oppression; second, the circumstances of the case

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<sup>109</sup> *Budd v. Gentra Inc.* supra note 103

<sup>110</sup> *Scotia Mcleod Inc. v. Peoples Jewellers Limited* (1995), 26 O.R.(3d) 481 (C.A.)

<sup>111</sup> *Budd v. Gentra Inc* supra note 103 at para 35

<sup>112</sup> *ibid* at para 33

<sup>113</sup> *ibid* at para 40

must make it “fit” or “appropriate” for the director to personally compensate the aggrieved parties.’<sup>114</sup> The court cited situations where orders against directors in their personal capacities may be appropriate such as:

- where directors have obtained a personal financial benefit from the conduct in question;
- where directors have increased their control of the corporation by means of oppressive conduct;
- where directors have breached a personal duty that they owe *qua* director;
- where directors have clearly misused corporate powers; and
- where imposing a remedy against the corporation will prejudice its innocent security holders.<sup>115</sup>

The principles developed by the Canadian courts in these cases regarding director liability in oppression cases may influence South African courts to also order directors to compensate shareholders in terms of s 163(2)(j). Plausibly the court could also have made compensation orders against directors in terms of s 252 given the wide discretion the court had under that section. However, there is a dearth of cases where courts actually ordered directors to personally compensate aggrieved parties in terms of s 252. The reason for this is not clear. One can only surmise that it may be that the applicants never sought relief of that nature and, hence the court never ordered it. However, it must be noted that although it was incumbent on the applicant to formulate the relief sought for, the court had a discretion to order relief which it deemed fit and, it was not bound by the relief sought by the applicant.<sup>116</sup> Hence it may be that the court did not perceive itself as having power to order directors to personally compensate the aggrieved party. Whatever the case may have been, it is submitted that the express wording of s 163(2)(j), as well as the decisions of Canadian courts noted earlier, make it more likely than ever before that directors may be ordered to personally compensate aggrieved parties in oppression cases.

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<sup>114</sup> See SN. Salter ‘When does ‘oppression’ merit personal liability for directors’ Available at [http://www.farris.com/images/pdf\\_archive/SNS-DirectorArticle.pdf](http://www.farris.com/images/pdf_archive/SNS-DirectorArticle.pdf), accessed 26 September 2014.

<sup>115</sup> *Budd v. Gentra Inc.* supra note 103 at para 52

<sup>116</sup> MS Blackman, RD Jooste & GK Everingham *et al* op cit note 4 at 9 – 46

Hence s 163 of the new Act provides an expansive remedy which gives courts wide discretion to make remedial orders against oppressive or prejudicial conduct as they see fit. Experience elsewhere shows that the remedy can be used effectively as a judicial brake against abuse of corporate powers. It is encouraging that in *Grancy Property Limited v Manala and Others*<sup>117</sup> the South African Supreme Court of Appeal took cognisance of the expansive nature of the oppression remedy as provided for in s 163(1) of the new Act and evinced its readiness to construe s 163(1) in a manner that will advance the remedy that it provides rather than limit it.

The oppression remedy and the derivative action discussed in this chapter are not the only remedies available to shareholders under the new Act. There are other remedies such as the application for an order declaring a director delinquent or under probation which is also significant in ensuring that directors are accountable to shareholders. The other remedies available under the new Act will be discussed in the next chapter.

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<sup>117</sup> *Grancy Property Limited v Manala and Others* supra note 79 at para 26

## CHAPTER 6: OTHER REMEDIES AND THE APPOINTMENT AND REMOVAL OF DIRECTORS

### **6.1 Introduction**

This chapter continues the discussion commenced in chapter 5 concerning the remedies available to shareholders in the new Act and how these impact on the balance of power between shareholders and directors. The remedies discussed in this chapter include the innovative remedy entitling shareholders, amongst others, to apply to a court for an order declaring a director delinquent or placed under probation.<sup>1</sup> The latter part of this chapter will discuss how the new Act regulates the power of shareholders to appoint and remove directors as this has a bearing on the balance of power between shareholders and directors.

#### **6.2.1 Application to declare a director delinquent or placed on probation**

Section 162 of the new Act entitles corporate stakeholders, including shareholders, to apply to court for an order declaring a director delinquent or placed under probation. A diverse class of persons is accorded legal standing by s 162 to bring such an application. This includes a company, a shareholder, director, company secretary or prescribed officer of a company, a registered trade union that represents employees of the company or another representative of the employees of a company,<sup>2</sup> the Commission, the Takeover Regulation Panel [hereafter ‘the TRP’]<sup>3</sup> and any organ of state responsible for the administration of any legislation.<sup>4</sup>

Notably, the application for an order declaring a director delinquent or placed under probation may be made against a current director as well as a person who was a director of a company within the 24 months immediately preceding the application.<sup>5</sup> This is commendable; it ensures that a director will not be able to escape the consequences of his wrong doing even if he resigns or is removed from his position as a director.

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<sup>1</sup> Section 162 of the new Act

<sup>2</sup> Section 162(2) of the new Act

<sup>3</sup> Section 162(3) of the new Act

<sup>4</sup> Section 162(4) of the new Act

<sup>5</sup> Sections 162(2)(a); 162(3)(a) and s 162(4)(a) of the new Act

### **6.2.2 Grounds for and consequences of a declaration of delinquency**

The grounds upon which a court may declare a director delinquent are set out in s 162(5) which provides that:

‘A court must make an order declaring a person to be a delinquent director if the person-

- (a) consented to serve as a director, or acted in the capacity of a director or prescribed officer, while ineligible or disqualified in terms of section 69, unless the person was acting-
  - (i) under the protection of a court order contemplated in section 69(11); or
  - (ii) as a director as contemplated in section 69(12);
- (b) while under an order of probation in terms of this section or section 47 of the Close Corporations Act, 1984 (Act No. 69 of 1984), acted as a director in a manner that contravened that order;
- (c) while a director-
  - (i) grossly abused the position of director;
  - (ii) took personal advantage of information or an opportunity, contrary to section 76(2)(a);
  - (iii) intentionally, or by gross negligence, inflicted harm upon the company or a subsidiary of the company, contrary to section 76(2)(a);
  - (iv) acted in a manner-
    - (aa) that amounted to gross negligence, wilful misconduct or breach of trust in relation to the performance of the director’s functions within, and duties to, the company; or
    - (bb) contemplated in section 77(3)(a), (b) or (c);
- (d) has repeatedly been personally subject to a compliance notice or similar enforcement mechanism, for substantially similar conduct, in terms of any legislation;
- (e) has at least twice been personally convicted of an offence, or subjected to an administrative fine or similar penalty, in terms of any legislation; or
- (f) within a period of five years, was a director of one or more companies or a managing member of one or more close corporations, or controlled or participated in the control of a juristic person, irrespective of whether concurrently, sequentially or at unrelated times, that were convicted of an offence, or subjected to an administrative fine or similar penalty, in terms of any legislation, and -
  - (i) the person was a director of each such company, or a managing member of each such close corporation or was responsible for the management of each such juristic person, at the time of the contravention that resulted in the conviction, administrative fine or other penalty; and
  - (ii) the court is satisfied that the declaration of delinquency is justified, having regard to the nature of the contraventions, and the person's conduct in relation to the management, business or property of any company, close corporation or juristic person at the time.’

The consequences of a declaration of delinquency are stated in s 69(8)(a) which provides that, ‘a person is disqualified to be a director of a company if a court has...declared the person to be delinquent in terms of section 162.’ In *Kukama v Lobelo* the court noted that an

order declaring a director delinquent has an automatic inherent effect of removing the director from his position as such hence it is not necessary for the court to order the removal of the delinquent director.<sup>6</sup>

In terms of s 162(6)(a) and (b) a declaration of delinquency which is made in terms of:

- ‘(a) subsection (5)(a) or (b) is unconditional, and subsists for the lifetime of the person declared delinquent; or
- (b) subsection (5)(c) to (f)-
  - (i) may be made subject to any conditions the court considers appropriate, including conditions limiting the application of the declaration to one or more particular categories of companies; and
  - (ii) subsists for seven years from the date of the order, or such longer period as determined by the court at the time of making the declaration, subject to subsections (11) and (12)’

Therefore, the duration and conditions attaching a declaration of delinquency is dependent on the grounds upon which the order is made. In terms of s 162(10)(a) to (c) a court may order, as conditions applicable or ancillary to a declaration of delinquency, that the person concerned:

- ‘(a) undertake a designated programme of remedial education relevant to the nature of the person’s conduct as director;
- (b) carry out a designated programme of community service;
- (c) pay compensation to any person adversely affected by the person’s conduct as a director, to the extent that such a victim does not otherwise have a legal basis to claim compensation.’

In terms of s 162(11)(a) and (b) a person who has been declared delinquent, other than as contemplated in subsection (6)(a), may apply to a court-

- ‘(a) to suspend the order of delinquency, and substitute an order of probation, with or without conditions, at any time more than three years after the order of delinquency was made; or
- (b) to set aside an order of-
  - (i) delinquency at any time more than two years after it was suspended as contemplated in paragraph (a); or
  - (ii) of probation, at any time more than two years after it was made.’

And on considering an application contemplated in subsection (11), the court may-

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<sup>6</sup> *Msimang NO and another v Katuliiba* [2013] 1 All SA 580 (GSJ) para 32. See also *Kukama v Lobelo and Others* [2012] JOL 28828 (GSJ)

‘(a) not grant the order applied for unless the applicant has satisfied any conditions that were attached to the original order, or imposed in terms of subsection (11)(a); and (b) grant an order if, having regard to the circumstances leading to the original order, and the conduct of the applicant in the ensuing period, the court is satisfied that- (i) the applicant has demonstrated satisfactory progress towards rehabilitation, and (ii) there is a reasonable prospect that the applicant would be able to serve successfully as a director of a company in the future.’

The use of the word ‘must’ in s 162(5) of the new Act indicates that once any of the grounds listed in the section is established the court has no discretion whether or not to grant the order – it is obliged to make an order declaring the person concerned to be a delinquent director.<sup>7</sup> It is clear from the above provisions that s 162 has serious repercussions for delinquent directors. Notably the consequences of a declaration of delinquency could potentially affect the director concerned even across the borders of South Africa.<sup>8</sup> For instance, section 206(B)(6) of the Australian Corporations Act 2001 prohibits a person from managing a corporation in Australia if that person is disqualified by a court order made by a court of a foreign jurisdiction from being a director of a company or, being concerned in the management of a company. Likewise a person who has been declared delinquent under s 162(5) may also be prohibited from becoming a company director in New Zealand in terms of s 383(1)(ca) of the New Zealand Companies Act of 1993. Section 383(1)(ca) provides that:

Where a person has been prohibited in a country, State, or territory outside New Zealand from carrying on activities that the court is satisfied are substantially similar to being a director or promoter of or, being concerned or taking part in the management of a body corporate... the court may make an order that the person must not, without the leave of the court, be a director or promoter of, or in any way, whether directly or indirectly, be concerned or take part in the management of a company permanently or for a period specified in the order.

As noted earlier, the ultimate consequence of a declaration of delinquency is the disqualification, and removal of the director concerned. Comparative jurisdictions such as, for example Australia, UK and New Zealand also have provisions in terms of which directors may be disqualified albeit such provisions are not worded like our s 162. For instance, s 383(3) of the New Zealand Companies Act, accords standing to, *inter alia*, a person who is, or has been a shareholder of a company to apply to court for an order disqualifying a person from being a director of a company where any of the grounds set out in s 383(1) of that Act are satisfied. The grounds in respect of which a director may be disqualified under s 383 are

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<sup>7</sup> *Msimang NO & Another v Katuliiba and Others* supra note 6 at para 31.

<sup>8</sup> *Lewis Group Limited v Woolman and Others* [2016] ZAWCHC 130

generally similar to the grounds upon which a director may be declared delinquent under our s 162. For example, a director may be disqualified where he has been convicted of an offence<sup>9</sup> or, has been guilty of a breach of duty to the company;<sup>10</sup> or, where he has acted in a reckless or incompetent manner in the performance of his or her duties as a director.<sup>11</sup> This echoes the grounds in ss 162(5)(e) & (c)(i)-(iv) of our Act.

It appears that under s 383(1) of the New Zealand Act a court has discretion as to whether or not to disqualify a director where any of the grounds contemplated in that section has been satisfied. Where any of the grounds has been satisfied, s 383(1) provides that ‘the court *may* make an order...,’ that the person concerned must not, *inter alia*, become a director of a company without the leave of the court (writer’s emphasis). This contrasts with our s 162(5) in terms of which, as noted above, the ‘court *must* make an order declaring a person to be a delinquent director,’ – and hence disqualified – where any of the grounds prescribed by the Act is satisfied. In this respect our Act is less forgiving of directors than the New Zealand Act – the court is obliged to declare a director delinquent once any one of the prescribed grounds has been proved. With regard to the period which a disqualification order remains in force, s 383(1) provides that in serious cases the court may make an order that is permanent or, which subsists for a period longer than 10 years. This is similar to our s 162(2) in terms of which, as noted above, a declaration of delinquency may subsist for the lifetime of the person declared delinquent or, it may subsist for seven years or such longer period as determined by the court.

In the UK directors may be disqualified in terms of the Company Directors’ Disqualification Act, 1986. In terms of that Act there are three broad categories of conduct in respect of which a court may, or in certain circumstances must<sup>12</sup>, make a disqualification order prohibiting the person concerned from *inter alia* becoming a director of a company except with the leave of the court. The first category of conduct is general misconduct in connection with companies. In this category a director may be disqualified if he has, for

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<sup>9</sup>Section 383(1)(a) &(b) of the New Zealand Companies Act of 1993

<sup>10</sup> Section 383(1)(c)(ii) of the New Zealand Companies Act of 1993

<sup>11</sup> Section 383(1)(c)(iii) of the New Zealand Companies Act of 1993

<sup>12</sup> Section 1(1) of the UK Company Directors Disqualification Act of 1986. the court is obliged to make a disqualification order against a person in any case where it is satisfied that the person is or has been a director of a company which has at any time become insolvent (whether while he was a director or subsequently), and that his conduct as a director of that company (either taken alone or taken together with his conduct as a director of any other company or companies) makes him unfit to be concerned in the management of a company.



example, been convicted of an indictable offence,<sup>13</sup> or has persistently been in default in relation to provisions of the companies legislation as per section 3(1) of the UK Company Directors Disqualification Act 1986. The latter provision is similar to, but more flexible and narrower than, our s 162(5)(d). It is more flexible in that the court has discretion whether or not to make an order disqualifying the director in question. In terms of s 162(5)(d) the court has no discretion. It is narrower in that the conduct in respect of which a director may be disqualified is limited to persistent default in relation *to companies legislation*. Under our s 162(5)(d) a director must be declared delinquent if he ‘has repeatedly been personally subject to a compliance notice or similar enforcement mechanism, for substantially similar conduct, *in terms of any legislation*’ (own emphasis). It is also notable that in terms of s 3(5) of UK Company Directors Disqualification Act 1986 the maximum disqualification period for persistent breaches of companies legislation is 5 years. This is more lenient than the 7 years or more which the court may impose in terms of our s 162(6)(b)(ii).

The second category of conduct relates to disqualification for unfitness. Under this category the court must make a disqualification order against a person if, for example, it is satisfied that the person is or has been a director of a company which has become insolvent and, that his conduct as a director of that company makes him unfit to be concerned in the management of a company.<sup>14</sup> Matters that may be taken into account in determining the unfitness of a director include, inter alia, any misfeasance or breach of any fiduciary or other duty by the director in relation to the company.<sup>15</sup>

The third category of conduct in respect of which a director may be disqualified in the UK is classified as ‘other cases of misconduct.’<sup>16</sup> Under this category the court may make a disqualification order against a director if for example, the director in question participated in wrongful trading with the result that a court makes a declaration in terms of s 213 or 214 of the Insolvency Act 1986 that the director is liable to make a contribution to a company’s assets.<sup>17</sup> While a UK court has discretion in this circumstance, our Act adopts a different approach by requiring the court to declare a director delinquent if

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<sup>13</sup> Section 2 of the UK Company Directors Disqualification Act 1986

<sup>14</sup> Section 6 of the UK Company Directors Disqualification Act 1986

<sup>15</sup> Section 9 read with Schedule 1, para 1 of the UK Company Directors Disqualification Act 1986

<sup>16</sup> See the heading before section 10 of the UK Company Directors Disqualification Act 1986

<sup>17</sup> Section 10 of the UK Company Directors Disqualification Act 1986

he, amongst other things, acquiesced in the carrying on of the company's business recklessly or fraudulently.<sup>18</sup>

It is notable that in Australia only ASIC is empowered to apply to court for disqualification orders.<sup>19</sup> Hence it seems the Australian Corporations Act 2001 disempowers shareholders in this respect. The MBCA does not have what one might call director disqualification provisions as such. However a court may remove a director upon application by the corporation or by its shareholders if the court finds that the director engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion, with respect to the corporation and that removal is in the best interest of the corporation.<sup>20</sup> The court that removes a director may bar the director from re-election for a period prescribed by the court.<sup>21</sup>

In the light of the foregoing it appears that the remedy provided for in s 162(5) for a court declaring a director delinquent compares favourably with comparable provisions in other jurisdictions.

### ***6.2.3 Grounds for and consequences of an order of probation***

The grounds upon which a court may make an order place a person under probation are stated in s 162(7) which provides that:

- ‘A court may make an order placing a person under probation, if-
- (a) while serving as a director, the person-
    - (i) was present at a meeting and failed to vote against a resolution despite the inability of the company to satisfy the solvency and liquidity test, contrary to this Act;
    - (ii) otherwise acted in a manner materially inconsistent with the duties of a director;
  - or
  - (iii) acted in, or supported a decision of the company to act in, a manner contemplated in section 163(1); or
  - (b) within any period of 10 years after the effective date-
    - (i) the person has been a director of more than one company, or a managing member of more than one close corporation, irrespective of whether concurrently, sequentially or at unrelated times; and
    - (ii) during the time that the person was a director of each such company or managing member of each such close corporation, two or more of those companies or close corporations each failed to fully pay all of its creditors or meet all of its obligations, except in terms of-

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<sup>18</sup> Section 162(5)(c)(iv) read with s 77(3)(b) and s 22(1) of the new Act

<sup>19</sup> See sections 206C(1); 206D(1) and 206E(1) of the Australian Corporations Act 2001

<sup>20</sup> Section 8.09(a) of the MBCA

<sup>21</sup> Section 8.09(b) of the MBCA

- (aa) a business rescue plan resulting from a resolution of the board in terms of section 129; or
- (bb) a compromise with creditors in terms of section 155.’

The use of the word ‘may’ in s 162(7) means that even where the above grounds have been established the court has a discretion whether or not to make an order declaring a director under probation. This contrasts with the position under s 162(5) where a court ‘must’ declare a director delinquent if any of the grounds under that section is established. The essence of an order placing a person under probation, as per s 162(7), is that the person who has been placed under probation may not serve as a director except to the extent permitted by the order of probation. Section 162(9) provides that:

- ‘A declaration placing a person under probation-
- (a) may be made subject to any conditions the court considers appropriate, including conditions limiting the application of the declaration to one or more particular categories of companies; and
- (b) subsists for a period not exceeding five years, as determined by the court at the time it makes the declaration, subject to subsections (11) and (12).’

Some of the orders which a court may make as conditions applicable, or ancillary to an order placing a director on probation are similar to those listed in s 162(10)(a) to (c) with regard to a declaration of delinquency.<sup>22</sup> In addition, s 162(10)(d) further provides that in the case of an order of probation the court may order that the person concerned:

- ‘(i) be supervised by a mentor in any future participation as a director while the order remains in force; or
- (ii) be limited to serving as a director of a private company, or of a company of which that person is the sole shareholder.’

Hence probation may be seen as a period in which a person has to prove his fitness to hold office as a director by, amongst other things, undertaking a designated programme of remedial education relevant to the nature of the person’s conduct as director as provided for in s 162(10).

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<sup>22</sup> See para 6.2.2 where s 162(10)(a) to (c) is quoted

#### **6.2.4 Evaluation of the remedy for declaring a director delinquent or under probation**

The remedy provided for in section 162 for declaring a director delinquent or under probation has no equivalent in the old Act.<sup>23</sup> In *Grancy Property Limited and Another v Gihwala and Others; In Re: Grancy Property Limited and Another v Gihwala and Others*<sup>24</sup> the court said that s 162 ‘introduces a new civil remedy for those harmed by the conduct of delinquent directors.’ However it should be noted that the remedy is not only available to those that have suffered harm. It is more correct to say that the remedy is available to any of the classes of persons mentioned in ss 162(2), (3) and (4) in any of the circumstances prescribed in s 162(5) as discussed in 6.2.1 and 6.2.2 above.

Although the remedy can be said to be innovative, it is comparable in its effect to s 219 of the old Act. As stated earlier the effect of a declaration of delinquency is disqualification from the office of director. A similar result was obtainable under s 219(1) which provided that:

The Court may make an order directing that, for such period as maybe specified in the order, a person, director or officer shall not without the leave of the Court be a director of or in any way, whether directly or indirectly, be concerned or take part in the management of any company when-

- (a) such person, director or officer, has been convicted of an offence in connection with the promotion, formation or management of a company; or
- (b) the Court has made an order for the winding-up of a company and the Master has made a report under this Act stating that in his opinion a fraud has been committed-
  - (i) by such person in connection with the promotion or formation of the company; or
  - (ii) by any director or officer of the company in relation to the company since its formation; or
- (c) in the course of the winding-up or judicial management of a company it appears that any such person-
  - (i) has been guilty of an offence referred to in section 424, whether or not he has been convicted of that offence; or
  - (ii) has otherwise been guilty while an officer of the company of any fraud in relation to the company or of any breach of his duty to the company; or
- (d) a declaration has been made in respect of any person under section 424 (1).<sup>25</sup>

It can be seen from the above that there are similarities regarding the grounds for disqualification in terms of s 219 and the grounds for a declaration of delinquency – and

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<sup>23</sup> *Msimang NO & Another v Katuliiba and Others* supra note 6 at para 29

<sup>24</sup> [2014] ZAWCHC 97 para 155

<sup>25</sup> Section 424(1) provided for the personal liability of a director who acquiesced in carrying on the business of a company recklessly or with intent to defraud creditors or for any fraudulent purpose

hence disqualification – in terms of s 162. In *Grancy Property Limited and Another v Gihwala and Others*<sup>26</sup> the court said that ‘it is clear that all the categories of conduct provided for in section 162(5)(c) of the 2008 Companies Act, would have been covered by section 219(1)(c)(ii) of the 1973 Companies Act (dealing with the disqualification of a director).’

The High Court rightly noted in *Grancy Property Limited and Another v Gihwala and Others*<sup>27</sup> that, ‘a comparison of the severity of the respective sanctions under the two Acts cannot really be made in the abstract, but should rather be done on a case by case basis.’ Some significant differences between s 162 and s 219(1) are highlighted below.

In terms of the severity of a disqualification order, the old Act did not stipulate minimum or maximum periods of removal. The court had discretion in terms of s 219(1) to make a disqualification order and to set the period for its operation.<sup>28</sup> On the other hand, as observed earlier, s 162(5) obliges a court to make a declaration of delinquency where the grounds listed in that section are satisfied. Further, the new Act prescribes minimum periods for which a declaration of delinquency subsists; this could be seven years or, the lifetime of the person declared delinquent depending on the grounds upon which the declaration is made.<sup>29</sup>

With regard to the effect of a disqualification order in terms s 219(1), the affected person was not only disqualified from acting as a director of a company but, he also could not ‘in any way, whether directly or indirectly, be concerned or take part in the management of any company...’ On the other hand, the effect of s 162(6) read with s 69 of the new Act is that a person who is declared delinquent is disqualified from being a company director but, it seems that he/she can take part in the management of a company. When considered from this perspective the old Act appears to have more severe consequences than the new Act for the person concerned.

Another significant difference between s 219(1) and s 162 is that in terms of the latter provision the court has a discretion to make a declaration of delinquency ‘subject to any conditions the court considers appropriate, including conditions limiting the application of the

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<sup>26</sup> *Grancy Property Limited and Another v Gihwala and Others; In Re: Grancy Property Limited and Another v Gihwala and Others* supra note 24 at para 175

<sup>27</sup> Ibid at para 178

<sup>28</sup> MS Blackman, RD Jooste & GK Everingham et al *Commentary on the Companies Act* (2002) Volume 2 at 8 – 278

<sup>29</sup> See s 162(6)(a) and (b) quoted in para 6.2.2 above

declaration to one or more particular categories of companies.’<sup>30</sup> By contrast it would seem that in terms of s 219(1) the court did not have the discretion, when disqualifying a person from acting as a director to grant that person leave to be a director of, or to be concerned with or take part in the management of, a particular company or companies.<sup>31</sup> In this respect a disqualification order in terms of s 219(1) always had a blanket effect in that it disqualified the affected person from being a director or from participating in the management of any company and not just a particular company or companies.

Further the discretion conferred on the court by s 162 enables the court to make significant remedial orders ancillary to a delinquency declaration. For instance, in terms of s 162(10)(a) and (c) respectively, the court can, in addition to declaring a director delinquent, order that the director in question:

- ‘(a) undertake a designated programme of remedial education relevant to the nature of the person’s conduct as a director...
- (c) pay compensation to any person adversely affected by the person’s conduct as a director, to the extent that such a victim does not otherwise have a legal basis to claim compensation...’

In comparison the court could only make a disqualification order in terms of s 219(1) but it could not for instance order the director concerned to pay compensation to any person adversely affected by the directors’ conduct.

Some commentators have questioned why s 162(10) of the new Act makes provision for an order to pay compensation where the victim would otherwise not have a legal basis to claim compensation.<sup>32</sup> They question why a director who has been declared delinquent or placed under probation should be ordered to pay compensation to a victim in circumstances when such an order would not ordinarily have been made under the principles of contract or the law of delict.<sup>33</sup> It is submitted that the answer to this is that by enacting s 162 the legislature sought to ensure that a person adversely affected by a director’s conduct would have an effective remedy.<sup>34</sup> To this end the legislature, in the very clear language of s 162, created a cause of action that is in its own class and, quite distinct from the principles of contract or law of delict. Overlaying the principles of the law of delict or contract on s 162

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<sup>30</sup> Section 162(6)(b)(i)

<sup>31</sup> See MS Blackman, RD Jooste and GK Everingham *et al* op cit note 28 at 8 – 278

<sup>32</sup> See FHI Cassim, MF Cassim, R Cassim *et al Contemporary Company Law* 2ed (2012) at 438

<sup>33</sup> *ibid*

<sup>34</sup> *Grancy Property Limited and Another v Gihwala and Others; In Re: Grancy Property Limited and Another v Gihwala and Others* supra note 24 at para 154.3

would diminish the effectiveness of this corporate law remedy and it would fly in the face of the clear intention of the legislature expressed in s 162(10)(c) that an effective remedy should be available in those circumstances where the victim ‘*does not otherwise have a legal basis to claim compensation.*’

Apart from the consequences discussed above, s 69(13) of the Act requires the Commission to establish and maintain a public register of persons disqualified from serving as a director or who are subject to an order of probation as a director in terms of a court order pursuant to the Act or any other law. This requirement is similar to the requirement contained in s 219(4A)(c) of the old Act where the Registrar of companies was required to establish and maintain a register of disqualification orders and the names of the persons to which the orders relate. Section 69(13) is supported by the Johannesburg Stock Exchange(JSE) Listing Requirements which prescribe that details of any court order declaring directors of an issuer – a company admitted to the list – delinquent or placing them under probation be included in pre-listing statements and circulars relating to rights offers, capitalisation issues and Category 1 or 2 transactions.<sup>35</sup>

It is submitted that the exposure to negative publicity likely to arise from the inclusion of one’s name in such public documents should motivate directors to honour their duties conscientiously. These public records of directors who have been declared delinquent or placed on probation should also assist companies in appointing fit and proper individuals to their boards by avoiding those candidates who have proven themselves incapable of managing companies or who failed to honour their duties as directors. All of this should generally contribute to good corporate governance in South Africa.

To the extent that s 162 provides shareholders a remedy against directors who inter alia grossly abuse their positions or, fail to honour their statutory duties, it complements and strengthens other mechanisms in the Act for holding directors accountable such as the statutory duties. Although there is a possibility that a director who has been declared delinquent may apply for relief in terms of s 162(11) by asking for the suspension of the order of delinquency or for the setting aside of an order of delinquency or probation under certain circumstances, such relief will only be ordered if the court is satisfied that, amongst

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<sup>35</sup> Section 7. B.2. (m) of the Johannesburg Stock Exchange (JSE) Listing Requirements, available at <https://www.jse.co.za/content/JSERulesPoliciesandRegulationItems/JSE%20Listings%20Requirements.pdf> , accessed 23 March 2015. Category 1 and 2 transactions are mainly acquisitions and disposals by listed companies as described in s 9 of the Listings Requirements. See R Cassim ‘Delinquent directors under the Companies Act 2008’ [2013] *DEREBUS* 14

other things, the applicant has satisfied any conditions that were attached to the original order and if the applicant has demonstrated satisfactory progress towards rehabilitation.<sup>36</sup> Accordingly the relief contemplated in s 162(11) is not simply there for the applicant's asking. Moreover, even if the court grants the relief, the director concerned would still have to contend with the dishonour and damage to reputation arising from the fact that an order of delinquency or probation was made.<sup>37</sup>

The remedy of having a director declared delinquent or placed under probation should prove to be effective in holding directors accountable. It is encouraging that thus far the courts have shown their readiness to declare errant directors delinquent in the case of *Msimang NO & Another v Katuliiba and Others* and also in *Kukama v Lobelo and Others*. In *Msimang NO & Another v Katuliiba and Others*<sup>38</sup> the court found that the failure of the directors concerned to attend to the preparation of the annual financial statements of the company since the financial year ending 28 February 2004 and also to convene the company's annual general meeting since the financial year ending 28 February 2006 constituted gross negligence and wilful misconduct. Accordingly, the court declared the directors delinquent in terms of s 162(5)(c)(iv)(aa). In *Kukama v Lobelo and Others* the court also declared the director concerned delinquent in terms of the same provision. In that case the court found the director guilty of, amongst other things, gross negligence for failing to detect a fraud of R39 million perpetrated against the South African Revenue Service (SARS) and which resulted in a refund to the company in that amount. The court also found that the director's failure to pay back a refund to SARS or, to the bank account that had been opened to service the company's value added tax obligations constituted 'wilful misconduct or breach trust as envisaged in section 162(5)(c)(iv)(aa) and (bb)'.<sup>39</sup>

The constitutional validity of s 162 was challenged by the respondent directors against whom a delinquency declaration was sought in *Grancy Property Limited and Another v Gihwala and Others*<sup>40</sup>. In particular, the respondents argued, *inter alia*, that s 162(5)(c) was unconstitutional in that, 'the wide scope, inflexible application and severe consequences thereof violate the constitutional rights of directors to dignity and to freely practise their

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<sup>36</sup> Section 162(12)

<sup>37</sup> R Cassim op cit note 35

<sup>38</sup> *Msimang NO & Another v Katuliiba and Others* supra note 6 at paras 69-70

<sup>39</sup> *Kukama v Lobelo and Others* supra note 6 at para 13

<sup>40</sup> *Grancy Property Limited and Another v Gihwala and Others; In Re: Grancy Property Limited and Another v Gihwala and Others* supra note 24



trade, occupation or profession (sections 10 and 22 of the Constitution, 1996).’<sup>41</sup> They further argued that the provision ‘affords the court no discretion to refrain from granting a delinquency declaration or to shorten the duration thereof. To that extent, the section deprives a court of its power to fashion an appropriate remedy and thus violates the separation of powers.’<sup>42</sup>

The court held that s 162(5)(c) did not infringe the rights of the respondents under ss 10 and 22 of the Constitution. It concluded inter alia that the lack of a discretion regarding an order of delinquency and also in relation the period of the order of delinquency was rationally related to the objectives of s 162 namely, to eliminate rogue directors from operating in South Africa to protect investors, as well as to boost confidence in the South African Regulatory System in order to attract investments and stimulate growth. With regard to the argument that s 162(5)(c) infringed the director in question’s right to human dignity and integrity the court said it was difficult to understand how this right could be violated where a director is removed on valid and substantial grounds as set out in the Act. It noted that ‘if this were to be the case, then it would be impossible for shareholders to remove rogue directors because such a removal would inevitably affect the directors’ dignity and integrity.’<sup>43</sup>

The court went on to find that on the facts of the case the directors in question had grossly abused their positions as directors in that they had taken personal advantage of information or opportunities at their disposal, in their capacity as directors, to gain advantages for themselves. Further the court found their conduct constituted repeated unlawful misappropriation of funds involving substantial amounts. Accordingly, it declared them delinquent in terms of s 162(5)(c).

These cases demonstrate that s 162 is a potent remedy which provides protection to companies and their stakeholders. In the light of the foregoing discussion it is submitted that though the new Act appears to have shifted the balance of power between shareholders and directors in favour of the latter by increasing the powers of directors, the new Act has also exposed directors to greater liability through the innovative remedy in s 162. Not only does s 162 make directors accountable to the company, it also makes them accountable to shareholders and other stakeholders such as employees and enforcement institutions such as

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<sup>41</sup> Ibid at para 151.1

<sup>42</sup> Ibid at para 151.2

<sup>43</sup> *Grancy Property Limited and Another v Gihwala and Others; In Re: Grancy Property Limited and Another v Gihwala and Others* supra note 24 at para 197

the Commission. In this respect it is encouraging that recent press reports show that the Commission is taking an ‘increasingly proactive approach’ in holding boards of companies to account for failures in corporate governance.<sup>44</sup> It is submitted that s 162 is set to contribute to higher standards of directors’ conduct and thus enhance corporate governance in South Africa.

### **6.3 Application to protect the rights of securities holders**

In terms of s 161(1)(a) a securities holder<sup>45</sup> may apply to court for an order determining any rights of that securities holder in terms of the Act, the company’s memorandum of incorporation (MOI) or any rules of the company. Section 161(1)(b) further provides that:

‘(1) A holder of issued securities of a company may apply to a court for-

(b) any appropriate order necessary to-

(i) protect any right contemplated in paragraph (a); or

(ii) rectify any harm done to the securities holder by-

(aa) the company as a consequence of an act or omission that contravened this Act or the company’s Memorandum of Incorporation, rules or applicable debt instrument, or violated any right contemplated in paragraph (a); or

(bb) any of its directors to the extent that they are or may be held liable in terms of section 77.’

The remedy introduced by s 161 is new and it is supplementary to any other remedy available to a securities holder in terms of the Act or in terms of the common law.<sup>46</sup> Arguably the remedy contemplated by a 161(1)(b)(ii)(bb) to rectify any harm done to the securities holder by any of the company’s directors may include an order that the director in question compensate the securities holder for any damage suffered. In this regard it is noteworthy that the shareholder’s right to apply for a court order to rectify any harm caused by any of the company’s directors is based on ‘the extent that they are or may be held liable in terms of section 77.’<sup>47</sup> Section 77 deals with the liability of directors for, *inter alia*, breach of their duties and which duties are generally owed to the company.<sup>48</sup> In the light of this and, depending on the facts of the case, it is likely that the reflective loss principle could apply.

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<sup>44</sup> L Ensor ‘Boards of five state-owned companies risk being declared delinquent,’ *Business Day Live*, 18 September 2014, available at <http://www.bdlive.co.za/companies/2014/09/18/boards-of-five-state-owned-companies-risk-being-declared-delinquent>, accessed 22 September 2014.

<sup>45</sup> The definition of ‘securities’ in s 1 of the new Act includes a share.

<sup>46</sup> Section 161(2) of the new Act; P Delpont, Q Vorster, D Burdette et al *Henochsberg on the Companies Act 71 of 2008* (2011) at 558

<sup>47</sup> Section 161(1)(b)(ii)(bb)

<sup>48</sup> FHI Cassim, MF Cassim, R Cassim *et al* op cit note 35 at 818

In terms of the reflective loss principle, if a company suffers loss as a result of breach of a duty owed to it, ‘no action lies at the suit of a shareholder, suing in that capacity and no other, to make good a diminution in the value of the shareholder’s shareholding where that merely reflects the loss suffered by the company.’<sup>49</sup> The reflective loss principle also dictates that, ‘where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it...’ Therefore it would seem that a shareholder would be able to seek redress under s 161 where the shareholder has suffered harm independent from the harm suffered by the company.

#### **6.4 Remedies in terms of ss 20(4), (5) and (6)**

Other notable new shareholders’ rights and remedies introduced by the new Act are to be found in ss 20(4), (5) and (6).

In terms of s 20(4) a shareholder, amongst other classes of people, may apply to the High Court for an appropriate order to restrain the company from doing anything inconsistent with the Act. Although this remedy is against the company per se, it impacts on the balance of power between directors and shareholders. For it must be remembered that the company is a juristic person<sup>50</sup> and that the Act invests the board of directors with the authority to exercise all the powers and perform any functions of the company<sup>51</sup>. Therefore, s 20(4) provides the means by which shareholders may check the exercise of those powers vested in the directors should the directors, in the exercise of the powers and, in the performance of the functions of the company, cause the company to do anything contrary to the Act.

Section s 20(4), is supported by s 20(5) which enables, *inter alia*, a shareholder to apply to a High Court for an appropriate order to restrain the company or the directors from doing anything inconsistent with any limitation, restriction or qualification of the company’s capacity or the directors authority in terms of the company’s MOI.

A shareholder may also be able to bring an action for damages against directors in terms of s 20(6). This has already been discussed in chapter 4 so no further discussion will be undertaken here.

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<sup>49</sup> *Johnson v Gore Wood & Co* [2001] 1 All ER 481 (HL) at 502; *Itzikowitz v Absa Bank Ltd* 2016 (4) SA 432 (SCA); See also P Delpont *et al Henochsberg on the Companies Act 2008* op cit note 46 at 559

<sup>50</sup> See section 19(1)(a) of the Act

<sup>51</sup> Section 66(1) of the Act

## 6.5 Dissenting shareholders' appraisal right

The dissenting shareholders' appraisal right [hereafter 'the appraisal remedy'] provided for in s 164 of the new Act is another innovative remedy available to shareholders. There are various views concerning the purpose of the appraisal right.<sup>52</sup> One of the oft-cited purposes is that the appraisal right is an exit mechanism for shareholders who are opposed to fundamental corporate changes whose views are thwarted by majority approval of the fundamental transaction. The remedy allows the dissenters to sell their shares and exit the fundamentally changed company which no longer meets their investment expectations.<sup>53</sup>

More pertinently in the context of this thesis, it has also been said that the appraisal remedy constitutes a strategy for shareholders to exit the company with the fair value of their shares and thus reducing the agency costs caused by opportunistic agents namely the majority shareholders and, in some cases the directors who are in control of the company.<sup>54</sup> For instance, in the context of takeovers directors of a company may be tempted to act in their own interests because of financial perquisites promised them by a particular bidder whilst being biased against a rival offer that does not provide much in benefits for the directors personally but is actually better for the shareholders.<sup>55</sup> In such a case those who do not wish to carry the agency costs occasioned by the directors' opportunistic behaviour could exit the company with the fair value of their investment by using the appraisal right.

Another argument that has been advanced concerning the purpose of the dissenting shareholder's appraisal remedy is that the remedy acts as a check on management's bad decisions. The argument is that, the greater the number of dissenting shareholders who demand to be bought out, the greater the chance that the board will review the bad decision. If the board fails to reconsider the bad decisions by taking heed of the dissenting voices, the company could be faced with a huge cash drain. In the context of the new Act one of the

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<sup>52</sup> BM Wertheimer 'The shareholder's appraisal remedy and how courts determine fair value' (1998) 47 *Duke Law Journal* 613 at 614

<sup>53</sup> *ibid*

<sup>54</sup> R Kraakman, J Armour, P Davies *et al* *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 2 ed (2009) at 41

<sup>55</sup> FHI Cassim, MF Cassim, R Cassim *et al* op cit note 32 at 797. See also R Rose 'Your Shares Can't Buy Democracy' *Business Times*, Sunday 14 October 2014, available at <http://www.bdlive.co.za/business/bidvest/2014/09/21/the-last-word-your-shares-cant-buy-democracy>, accessed on 21 October 2014. In this press article it is alleged that the recently failed takeover bid for Adcock Ingram Holdings Limited was thwarted by the company's board of directors. The directors are said to have refused to place a takeover offer from the BIDVEST Group before the company's shareholders for a vote allegedly because BIDVEST had refused to give the company's management team assurances of continued employment after the takeover. The board reportedly favoured a rival takeover bid from a relatively unknown Chilean pharmaceutical company, CFR Pharmaceuticals.

policy objectives was to come up with ‘a remedy to avoid locking in minority shareholders in inefficient companies.’<sup>56</sup> It was said that an exit and appraisal remedy was needed to ‘provide smaller investors the ability to make informed choices, where they are unable to influence company direction and decisions effectively or to pursue private actions against the company in civil courts.’<sup>57</sup>

It is conceded that the appraisal right may not squarely fulfil all the purposes discussed above in every given circumstance. For it is conceivable that there may be a merger transaction in which the directors are not conflicted at all and where they have made a good business decision but the law still makes the remedy available in those circumstances. The availability of the remedy in such instances is not so much to provide an escape from the opportunism of directors or to provide a check against bad decisions by management. Rather the remedy is available to provide liquidity to the dissenter who is then able to cash in his investment in the company if he disagrees with the takeover deal. Notwithstanding the fact that the appraisal remedy may not fulfil all the purposes discussed above in every given circumstances, the remedy can plausibly fulfil one or the other of those functions depending on the facts of each case. Therefore, while the remedy is not a tool for directly holding directors accountable to shareholders, it does have an important role to play in corporate governance in that in certain instances it may act as a check against bad managerial decisions or it may also act as a strategy for shareholders to avoid the agency costs arising from fundamental transactions that are tainted by directors’ self-interest.

The appraisal remedy is not unique to South Africa. It also exists in foreign legislation such as, *inter alia*, the MBCA<sup>58</sup>, the Delaware General Corporations Law<sup>59</sup> and Canada Business Corporations Act.<sup>60</sup> Some of our appraisal right provisions are similar to the provisions of the Canada Business Corporations Act. For instance, our s 164 is similar to s 190 of the Canada Business Corporations. In terms of s 164 the dissenting shareholder’s appraisal right is triggered when the company has given notice to shareholders of a meeting to consider adopting a resolution to do any one of the following:

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<sup>56</sup> Paragraph 1.2.3 (c) of the Memorandum on the objects of the Companies Bill 2008 [B61 – 2008] (published in GG 31104 of 30 May 2008)

<sup>57</sup> Department of Trade and Industry Policy Paper *South African Company Law for the 21<sup>st</sup> Century*. (GN 1183 published in GG 26493 of 23 June 2004)

<sup>58</sup> Chapter 13 of the MBCA, sections 13.01 to 13.31

<sup>59</sup> Section 262 of the Delaware General Corporation Law

<sup>60</sup> Section 190 of the Canada Business Corporations Act (R.S.C., 1985, c. C-44)

- amend its MOI by altering the rights of any class of its shares in any manner that is materially adverse to the rights or interests of holders of that class of shares<sup>61</sup>
- enter into a fundamental transaction such as the disposal of all or a greater part of the company's assets or undertaking; an amalgamation or merger or a scheme of arrangement.<sup>62</sup>

This is comparable to s 190(1) of the Canada Business Corporations Act which provides as follows:

Subject to sections 191 and 241, a holder of shares of any class of a corporation may dissent if the corporation is subject to an order under paragraph 192(4)(d) that affects the holder or if the corporation resolves to

(a) amend its articles under section 173 or 174 to add, change or remove any provisions

restricting or constraining the issue, transfer or ownership of shares of that class;

(b) amend its articles under section 173 to add, change or remove any restriction on the

business or businesses that the corporation may carry on;

(c) amalgamate otherwise than under section 184;

(d) be continued under section 188;<sup>63</sup>

(e) sell, lease or exchange all or substantially all its property under subsection 189(3); or

(f) carry out a going-private transaction or a squeeze-out transaction.

The trigger events prescribed by our s 164 are also comparable to, but narrower than those contained in s 13.02(a) of the MBCA. In terms of the latter provision the appraisal remedy is triggered by a merger, a share exchange, disposition of a corporation's assets, and certain amendments to the corporation's articles of incorporation, conversion of the incorporation to non-profit status or, into an unincorporated entity. Section 164 is wider than s 262(6) of the Delaware General Corporation Code in terms of which the appraisal remedy is available in the event of a merger or consolidation of the corporation only. Hence the Delaware General Corporation Code is limited in the extent to which it protects minority shareholders in the context of fundamental corporate changes. For instance, minority shareholders in Delaware would not have the benefit of the appraisal right where a corporate takeover is effected by

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<sup>61</sup> Section 164(2)(a) read with s 37(8) of the new Act

<sup>62</sup> Section 164(2)(b) read with ss 112; 113 and 114 respectively

<sup>63</sup> This refers to the procedure whereby a company incorporated in one jurisdiction applies to the relevant authority in another jurisdiction for recognition and, to operate as if it had been incorporated under the laws of that other jurisdiction.

means of a sale of the corporation's assets.<sup>64</sup> Hence our s 164(2) better protects minority shareholders than s 262(6) of the Delaware General Corporation Code in that it makes the appraisal remedy available in the event of *inter alia*, a disposal of all or a greater part of a company's assets.

In terms of s 164(5) a tacit requirement for standing to exercise the appraisal remedy is that one must *inter alia*, be a shareholder of the company. It is not clear whether the term 'shareholder' in the context of s 164(5) includes a beneficial shareholder, hence it has been observed that it is not certain whether a beneficial shareholder would be entitled to exercise the appraisal right.<sup>65</sup> Beukes notes that in the context of s 190 of the Canada Business Corporations Act the general rule is that to have standing to exercise the appraisal remedy a dissenting shareholder must be a registered shareholder when the resolution approving the triggering transaction is passed.<sup>66</sup> He further notes that the rule is not strictly followed by the court and, 'it seems that a dissenting shareholder can employ the appraisal remedy whether he is a registered or beneficial shareholder.'<sup>67</sup> It appears the court in Canada makes an exception to the general rule by allowing beneficial shareholders to exercise the appraisal right in exceptional cases only, such as when a corporation files an inadequate or misleading circular regarding the triggering transaction.<sup>68</sup> Based on the approach of the court in Canada in relation to s 190 and, the similarity between that section and our s 164, Beukes argues<sup>69</sup> that since our Act does not explicitly restrict standing to registered shareholders, both registered and beneficial shareholders ought to have standing in terms of s 164. A contrary view is advanced by Delpont *et al*<sup>70</sup> who argue that under s 164 beneficial shareholders are precluded from exercising the appraisal remedy and, that the 'Canadian authorities should not apply here due to the differences in the definitions of "shareholder."' However, it is not clear what the 'differences in definitions' referred to by Delpont *et al* are. Section 190 of the Canada Business Corporations Act uses the terms 'holder of shares' and 'shareholder' but these terms are not defined in that Act. The terms have traditionally been defined by the court

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<sup>64</sup> Barry M Wertheimer *op cit* note 52 at 703

<sup>65</sup> Jacqueline Yeats 'The effective and proper exercise of appraisal rights under the South African Companies Act, 2008: developing a strategic approach through a study of comparable foreign law' (Unpublished PhD thesis, UCT 2016) at para 7.3.2. In terms of s 1 of the Act a 'shareholder' is defined thus 'subject to section 57(1) means the holder of a share issued by a company and who is entered as such in the certificated or uncertificated securities holder as the case may be.'

<sup>66</sup> HGJ Beukes 'An introduction to the appraisal remedy in the companies act 2008: standing and the appraisal procedure' (2010) 22 *SA Merc LJ* 176

<sup>67</sup> *ibid*

<sup>68</sup> *Lake & Co v Calx Resources Ltd* (1996) 30 BLR (2d) 186 (Alta CA)

<sup>69</sup> *ibid*

<sup>70</sup> P Delpont *et al Henochsberg on the Companies Act 2008* note 46 at 582(1)

to refer to a registered shareholder and not a beneficial shareholder.<sup>71</sup> This is generally similar to the definition of ‘shareholder’ in s 1 of our new Act. The traditional definition by the Canadian court forms the basis of the general rule noted earlier that, only registered shareholders can exercise the appraisal remedy under s 190. But as noted by Beukes, in some cases the Canadian court has deviated from the rule and allowed beneficial shareholders to exercise the appraisal remedy.<sup>72</sup>

While Beukes’ argument referred to above is appealing in that it would protect the rights of beneficial shareholders, it is not certain whether our courts would generally allow beneficial shareholders to exercise the appraisal right under s 164 by following what is essentially an exception to the general rule in Canada. It is likely that our court will take the literal meaning of the provisions of s 164 and hold that the term ‘shareholder’ in that section refers to a registered shareholder as defined in s 1. It is submitted that if the legislature had intended to expand the meaning of the term ‘shareholder’ in s 164 to include beneficial shareholders it would have done so expressly.<sup>73</sup> The fact that it did not do so is indicative of an intention to limit standing under s 164 to registered shareholders. Interpreting s 164 in this literal and narrow fashion would preclude beneficial shareholders from exercising the appraisal right and, it would be in accord with the general rule in Canada. The rationale for the general rule in Canada is to avoid placing an onerous burden and uncertainty on the corporation in question.<sup>74</sup> While this approach is rational and, it facilitates certainty for companies proposing to enter into fundamental transactions, its appropriateness has been questioned ‘in the context of modern capital markets where significant numbers of shares are registered in the names of depository agencies, brokerage firms or other nominees.’<sup>75</sup> Similarly, in South Africa some investors own shares through nominees who participate in the central securities depository (CSD) system managed by STRATE Ltd. Unless the nominee shareholder agrees to exercise the appraisal right for and on behalf of the beneficial shareholder, the latter would be precluded from exercising the appraisal rights under s 164 if a narrow and literal interpretation of that section is adopted.<sup>76</sup> In the light of the foregoing it would be helpful if the legislature could clarify the rights of beneficial shareholders with

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<sup>71</sup> *Westmin Resources Ltd. v. Hamilton* [1990] B.C.J. No. 2758 (S.C.) (QL).

<sup>72</sup> See for instance *Lake & Co v Calex Resources Ltd* supra note 68

<sup>73</sup> Indeed the definition of ‘shareholder’ in s 1 envisages that in certain contexts such as in s 57(1) the term may have wider connotations. See footnote...above for definition of shareholder

<sup>74</sup> *Westmin Resources Ltd. v. Hamilton* supra note 71 at 9

<sup>75</sup> Harry Sutherland, David B Horsely, Graham Turner et al ‘*Fraser & Stewart Company Law of Canada*’ 6ed (1993) at 575-576

<sup>76</sup> Jacqueline Yeats op cit note 65 at para 7.3.3



regard to the appraisal remedy by amending s 164 in such a way that it spells out whether, and under what circumstances a beneficial shareholder would be entitled to exercise the appraisal right.

It must be noted that granting beneficial shareholders standing to exercise the appraisal remedy is not without precedent, some foreign legislation<sup>77</sup> allows either the nominee shareholder to exercise the appraisal right on behalf of the beneficial shareholder or, the beneficial shareholder to exercise the appraisal right on his own behalf. For instance, s 13.03 of the MBCA provides as follows:

- (a) A record shareholder may assert appraisal rights as to fewer than all the shares registered in the record shareholder's name but owned by a beneficial shareholder only if the record shareholder objects with respect to all shares of the class or series owned by the beneficial shareholder and notifies the corporation in writing of the name and address of each beneficial shareholder on whose behalf appraisal rights are being asserted. The rights of a record shareholder who asserts appraisal rights for only part of the shares held of record in the record shareholder's name under this subsection shall be determined as if the shares as to which the record shareholder objects and the record shareholder's other shares were registered in the names of different record shareholders.
- (b) A beneficial shareholder may assert appraisal rights as to shares of any class or series held on behalf of the shareholder only if such shareholder:
  - (1) submits to the corporation the record shareholder's written consent to the assertion of such rights no later than the date referred to in section 13.22(b)(2)(ii); and
  - (2) does so with respect to all shares of the class or series that are beneficially owned by the beneficial shareholder

In Delaware the effect of s 262(d) read with s 262(a) of the Delaware General Corporation Code is that only the registered stockholder is entitled to deliver the appraisal demand to the corporation.<sup>78</sup> However, s 262(e) permits a beneficial shareholder to bring a petition for appraisal in his own name; it provides that,

Notwithstanding subsection (a) of this section, a person who is the beneficial owner of shares of such stock held either in a voting trust or by a nominee on behalf of such person may, in such person's own name, file a petition or request from the corporation the statement described in this subsection.

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<sup>77</sup> See for instance s 13.03 of the MBCA, s 262(e) of the Delaware General Corporations Code, subdivision 2 of s 302A.471 of the Minnesota Business Corporation Act, s 180.1302 read s 180.1301 of the Wisconsin Business Corporation Law, s 23B.13.030 of the Washington Business Corporation Act

<sup>78</sup> *DiRienzo v. Steel Partners Holdings L.P.* No. 4506-CC (Del Ch. Dec. 8, 2009). At para II B

Hence to be entitled to bring an appraisal petition in Delaware, a beneficial shareholder must ensure that the record holder of his or her shares makes the demand.<sup>79</sup>

In the light of the foregoing, foreign legislation could provide guidelines as to how our s 164 could be amended in order to clarify the rights of beneficial shareholders with regard to the appraisal remedy.

The complex and technical requirements of the appraisal procedure have also been flagged as factors that could impede the effectiveness of the appraisal remedy as a shareholder protection tool.<sup>80</sup> The Act sets out a series of mandatory procedural steps and notices that must be given within prescribed time limits failing which the dissenter may lose the appraisal right. In brief some of the pertinent provisions include 164(2) which require the dissenter to give the company written notice of his/her objections to the proposed transaction before the resolution proposing the transaction is voted on. Section 164(5) is also another key provision. It provides that a shareholder may make a demand that the company pay him the fair value for his shares if certain requirements set in that section are satisfied. The demand must be sent to the company within twenty business days after the dissenter received notice from the company that the resolution has been accepted.<sup>81</sup> A copy of the demand must also be delivered to the Takeovers Regulation Panel in terms of s 165(8). Beyond these and other procedural steps that must be fulfilled, it is important to note that the courts may also end up being involved in the appraisal process if a shareholder applies to court for the court to determine a fair value for his/her shares in terms of s 164(14).

Although the consequences of non-compliance with the procedural requirements of s 164 are not expressly stated, it is implicit in that section that failure to comply with the prescribed procedures and time limits on the part of the dissenting shareholder would result in him/her losing the appraisal right.<sup>82</sup> On the other hand failure on the part of the company to comply with its procedural obligations under s 164 does not appear to have any adverse repercussions for the company.<sup>83</sup> Hence the appraisal procedure affects the shareholder – who

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<sup>79</sup> *ibid*

<sup>80</sup> Jacqueline Yeats *op cit* note 65; See also FHI Cassim, MF Cassim, R Cassim *et al op cit* note 32 at 807; Ezra Davids, Trevor Norwitz and David Yuill 'A microscopic analysis of the new merger and amalgamation provisions in the Companies Act 71 of 2008' in Tshepo Mongalo (ed) *Modern Company Law for a Competitive South African Economy* at 360-361

<sup>81</sup> Section 164(7)(a) of the new Act

<sup>82</sup> See section 164(5)(a) & (c), especially 164(5)(c)(ii) read with s 164(7) of the new Act; See also C Stein and G Everingham *The New Companies Act Unlocked* (2011) at 300

<sup>83</sup> HGJ Beukes 'An introduction to the appraisal remedy as proposed in the companies bill' *op cit* note 66 at 487; FHI Cassim, MF Cassim, R Cassim *et al op cit* note 32 at 807

it is supposed to protect – more negatively than it does the company. It seems non-compliance with the time periods prescribed by s 164 cannot be excused under the substantial compliance provisions of the Act<sup>84</sup> because those provisions deal with condonation for non-compliance with the prescribed form, content or, manner of delivery of any document or notice.<sup>85</sup> In the absence of an express provision in s 164 empowering the court to condone non-compliance with the procedural requirements of that section it is possible that the court could consider that the provisions of the section preclude it from doing so. In *Vlok NO and Others v Sun International South Africa Ltd and Others*<sup>86</sup> a minority shareholder that was challenging a squeeze-out<sup>87</sup> applied to court for condonation of its non-compliance with a 30-day time period prescribed by s124(2) of the Act. The court dismissed the application for condonation and held *inter alia*, that<sup>88</sup> ‘despite the words of s 124(2) being concededly neutral and containing no express exclusion of a power to condone, the exclusion of a power to condone had to be implied into the subsection by way of necessary construction.’ In arriving at its decision the court took into account, amongst other things, the fact that the major purpose of s 124(2) was to avoid allowing the minority to oppress the new majority by holding the fate of its take-over bid to ransom. It noted that strict and absolutely applied time frames regarding any action to oppose the take-over bid were essential to the realisation of this objective.<sup>89</sup>

Similar reasoning to that applied by the court in the *Vlok* case could plausibly be used by the court to read into s 164 an implied exclusion of the court’s power to condone non-compliance with the procedural requirements of that section.<sup>90</sup> This would lead to dissenting shareholders losing their appraisal rights for failure to comply with the time periods prescribed by s 164. Therefore there is need to amend the Act so that it expressly empowers

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<sup>84</sup> Section 6(8) and 6(9)

<sup>85</sup> Jacqueline Yeats op cit note 65 at para 7.5.1.4

<sup>86</sup> *Vlok NO and Others v Sun International South Africa Ltd and Others* 2014 (1) SA 487 (GSJ)

<sup>87</sup> Where an offer for the acquisition of any class of securities of a company has been accepted by the holders of at least 90% of the securities of that class section 124(1) entitles the offeror to acquire the remaining securities of that class on the same terms as the original offer thus squeezing out the remaining minority securities holders of that class.

<sup>88</sup> *Vlok NO and Others v Sun International South Africa Ltd and Others* supra note 86 at para 110

<sup>89</sup> Ibid at para 105

<sup>90</sup> It appears that concerns have been raised to the effect that the exercise of appraisal rights could inhibit corporate activity and that it creates uncertainty for companies planning to enter into fundamental transactions as they are never sure of the financial consequences of a transaction. In this respect see Jacqueline Yeats ‘The effective and proper exercise of appraisal rights under the South African Companies Act, 2008: developing a strategic approach through a study of comparable foreign law’ (Unpublished PhD thesis, UCT 2016) at para 7.2. In the light of these concerns the court may reason that to prevent delays, and hence reduce the uncertainty occasioned by the appraisal procedure, there is need for strict and absolute application of the time periods set by s 164

the court to condone non-compliance with the requirements of s 164 in order to protect dissenting shareholders in appropriate circumstances such as, when there is a minor deviation from the prescribed procedure and where the deviation causes no harm to the company .

As discussed above, the appraisal procedure established by the Act envisages that the court may become involved in the appraisal process in particular, to determine the fair value of the shares that are the subject of a demand.<sup>91</sup> The involvement of the courts in the appraisal procedure gives rise to a number of issues that impact on the effectiveness of the appraisal remedy. One issue is that the court processes in South Africa are characterised by delays.<sup>92</sup> Consequently, a dissenting shareholder who does not accept an offer made by the company in terms of s 164(11) may have to wait a long time before he is paid the fair value of his shares as determined by the court. In this respect it is noteworthy that the shareholder will only be paid the fair value of his shares at the conclusion of the court proceedings in terms of s 164(15)(c)(v)(bb). This may act as a disincentive to the use of the appraisal remedy because a shareholder who makes a demand to be paid the fair value for his shares in terms of s 164(5) loses his rights in respect of those shares.<sup>93</sup> Moreover the delay occasioned by the enforcement of the appraisal remedy through the courts adds to the cost of litigation and, this may inhibit small shareholders from exercising the appraisal remedy.<sup>94</sup> With regard to the costs of litigation in South Africa it has been noted that,<sup>95</sup>

‘The most common general complaint about the current justice system in South Africa is that the cost of litigation is prohibitive. This prevents meaningful access to courts and even those with access are often victims of delay. For most litigants, delay means added expense and for many people justice delayed is justice denied. Delay combined with the cost of litigation has put justice beyond the reach of the ordinary citizen.’

The foregoing discussion highlighted some of the issues that could impact on the effectiveness of the appraisal remedy in protecting the interests of shareholders. Insight into possible solutions for some of the challenges discussed above can be gathered from the approaches taken in comparable jurisdictions. With regard to the challenge of the delays and

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<sup>91</sup> Section 163(14) of the new Act provides that a shareholder who has made a demand in terms of ss 164(5) to (8) may apply to a court to determine a fair value in respect of the shares that were the subject of that demand, and an order requiring the company to pay the shareholder the fair value so determined, if the company has failed to make an offer under s 164(11) or, if the company has made an offer which the shareholder considers to be inadequate, and that offer has not lapsed.

<sup>92</sup> See South African law Commission ‘*Alternative Dispute Resolution*’ Issue Paper 8, Project 94 (1997) at para 2.9. Available at [http://www.justice.gov.za/salrc/ipapers/ip08\\_prj94\\_1997.pdf](http://www.justice.gov.za/salrc/ipapers/ip08_prj94_1997.pdf) accessed 30 November 2016

<sup>93</sup> Section 164(9) of the new Act; see also Ezra Davids, Trevor Norwitz and David Yuill op cit note 80 at 360-361

<sup>94</sup> Ezra Davids, Trevor Norwitz and David Yuill op cit note 80 at 360-361

<sup>95</sup> *ibid*

costs of enforcing the appraisal right in court, it is notable that in other jurisdictions a company is obliged to or, is permitted to make a provisional payment to the dissenting shareholders pending a final determination of the fair value of the shares. For instance, s 112A(1)(b) of the New Zealand Companies Act of 1993 requires that where the share price determined by the company is objected to, the company must, within 5 working days of receiving the objection, pay to the shareholder a provisional price in respect of each share equal to the price offered by the board. Similarly s 13.24(a) of the MBCA obliges a corporation to pay the qualifying dissenting shareholders, prior to the conclusion of the appraisal proceedings, the amount which the corporation estimates to be the fair value of their shares.

A different approach is followed in s 262(h) of the Delaware General Corporation Law, as amended in 2016, which provides *inter alia* that,

At any time before the entry of judgment in the proceedings, the surviving corporation may pay to each stockholder entitled to appraisal an amount in cash, in which case interest shall accrue thereafter as provided herein only upon the sum of (1) the difference, if any, between the amount so paid and the fair value of the shares as determined by the Court, and (2) interest theretofore accrued, unless paid at that time.

The amended s 262(h) thus allows a corporation to make cash payments to dissenting shareholders prior to the conclusion of the appraisal proceedings. It is notable that the prepayments in terms of 13.24(a) of the MBCA and s 112(A)(1)(b) of the New Zealand Companies Act are obligatory while the prepayment in terms of s 262(h) of the Delaware Code is optional.

The prepayment provided for in the foreign legislation discussed above is significant in two respects. As is evident from s 262(h) of the Delaware Code quoted above, making a prepayment is beneficial for the company because it reduces interest accruals on the final fair value award made by the court. More pertinently, the prepayment provides funds for some dissenting shareholders' who might otherwise not have the cash to finance the appraisal proceedings.<sup>96</sup> Hence including a provision in our Act requiring the company to pay a dissenting shareholder a provisional amount pending a final determination of the fair value of the shares could financially empower shareholders to exercise the appraisal remedy.

It is also interesting to note that in other jurisdictions disputes concerning the fair value of shares in appraisal situations are not resolved through the courts. For instance, in

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<sup>96</sup> Jacqueline Yeats op cit note 65 para 3.2.6

New Zealand a dispute relating to the fair value of shares in an appraisal situation must be submitted to arbitration as per s 112A(1)(a) of the New Zealand Companies Act. This represents a legislative choice to make arbitration compulsory in the context of appraisal rights. This writer agrees with Yeats' observation that<sup>97</sup>,

‘Arbitration has some significant potential advantages over litigation in the context of appraisal rights because the parties can choose their own adjudicator (a significant advantage when dealing with complex valuation methodologies) and there is not much emphasis on formalistic legal proceedings which implies a greater ability to focus on the issues at hand and ultimately results in more efficient, private proceedings.’

It is noteworthy that s 166(1) of the new Act envisages that as an alternative to applying for relief to a court, or filing a complaint with the Commission, a person who would be entitled to apply for relief, or file a complaint in terms of the Act, may refer a matter that could be the subject of such an application or complaint for resolution by mediation, conciliation or arbitration. However, as discussed in para 6.7 below, the alternative dispute resolution process envisaged by s 166(1) is voluntary and parties are not obliged to participate in the proceedings.<sup>98</sup> Thus even if the company and a particular shareholder agree to refer a dispute concerning the valuation of shares in an appraisal situation to arbitration, other dissenting shareholders may refuse to participate in those proceedings. They could in fact choose to follow the litigation procedure provided for in s 164(5). This would put the company in an unenviable position of having to engage with more than one group of shareholders in different forums over the same matter.<sup>99</sup> In view of the advantages of arbitration over litigation alluded to above, our legislature should consider making arbitration compulsory in the context of s 164.

### **6.6.0 Appointment/election & removal of directors**

#### **6.6.1 Appointment/election of directors under the Companies Act**

##### **61 of 1973**

The power of shareholders to elect and remove directors from a company's board – shareholders appointment rights – is considered as one of the fundamental rights of

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<sup>97</sup> *ibid*

<sup>98</sup> *Omar v Inhouse Venue Technical Management (Pty) Limited and Others* 2015 (3) SA 146 (WCC) at para 75

<sup>99</sup> Jacqueline Yeats *op cit* note 65 at para 7.7.4

shareholders in corporate law.<sup>100</sup> Appointment rights provide scope for shareholders to determine who sits on the company's board; therefore the power to appoint and remove directors is an important tool by means of which shareholders can hold directors accountable.<sup>101</sup>

Section 208(1) of the old Act required a public company to have at least two directors and at least one director in the case of a private company. Only the shareholders had the power to appoint directors subject to the provisions of the company's articles.<sup>102</sup> In some cases the company's articles or a shareholders' agreement empowered a shareholder or a third party to nominate a director of their choice.<sup>103</sup>

### **6.6.2 Removal of directors under the Companies Act 61 of 1973**

With regard to the removal of directors, s 220(1)(a) of the old Act provided that,

‘A company may, notwithstanding anything in its memorandum or articles or in any agreement between it and any director, by resolution remove a director before the expiration of his period of office.’

In *Swerdlow v Cohen*<sup>104</sup> the court considered whether the reference to a ‘resolution’ in s 220(1)(a) referred to a special or an ordinary resolution. It held that ‘there can be little doubt that Parliament’s intention was to empower a company to exercise the rights accorded by the section by means of an ordinary resolution.’ Therefore the statement by Olson<sup>105</sup> that the old Act required a special resolution to remove a director is, with due respect, erroneous. Where a company proposed to remove a director by ordinary resolution the director concerned was entitled to be given notice of the proposed resolution. He was also entitled to be heard on the proposed resolution at the meeting in terms of s 220(2)(b). Section 220(1) was not the only avenue through which directors could be removed; s 220(7) provided inter alia that ‘nothing in this section shall be construed...as derogating from any power to remove a director which may exist apart from this section.’ Hence a company had an election concerning which procedure to follow when removing a director. For instance, instead of proceeding in terms of

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<sup>100</sup> J Velasco ‘The fundamental rights of the shareholder’ (2006) 40 *University of California, Davis Law Review* 407

<sup>101</sup> SM. Bainbridge, ‘Director primacy and shareholder disempowerment’ (2006) 119 *Harv. L. Rev.* 1735 at 1750. See also PL Davies *Gower and Davies Principles of Modern Company* 8 ed (2008)

<sup>102</sup> Section 209 read with s 210 of the old Act

<sup>103</sup> C Stein and G Everingham op cit note 82 at 224.

<sup>104</sup> *Swerdlow v Cohen* 1977 (3) SA 1050 (T) at 1053

<sup>105</sup> JF Olson ‘South Africa moves to a global model of corporate governance but with important national variations’ in T Mongalo *Modern Company law for a Competitive South African Economy* (2010) 219 at 237-238

s 220(1)(b), it could remove a director in terms of the provisions of the company's articles or, in terms of the common law if the articles were silent regarding the power to remove directors and the director's term of office.<sup>106</sup>

Therefore, section 220 accorded shareholders in general meeting an unrestricted power to remove directors in the sense that the power overrode any contrary provisions in the company's memorandum, or articles or in any agreement between the company and the director. Moreover, the company was not limited to the procedure set by s 220 when removing a director.

Significantly a director removed in terms of s 220(1) before the expiration of his term of office had a right of recourse against the company for breach of contract or damages in terms of s 220(7). That section provided that:

'Nothing in this section shall be construed as depriving a person removed thereunder of compensation or damages which may be payable to him in respect of the termination of his appointment as director or of any appointment terminating with that of director...'

The damages contemplated in s 220(7) were payable if, inter alia, the director in question had a contract with the company and, if the director had not committed a breach of the contract which entitled the company to terminate it.<sup>107</sup> Hence if a director occupied the position of a director in terms of a company's articles in the absence of a separate contract between him and the company, such a director had no claim for damages upon removal.<sup>108</sup> The reason for this was that the articles do not constitute a contract between the company and a director in his capacity as such.<sup>109</sup>

Although s 220(1) empowered shareholders to remove directors by ordinary resolution, it is noteworthy that the section could be circumvented by means of inter alia, an agreement between shareholders and a director or, a voting agreement between shareholders.<sup>110</sup> For instance, in *Amoils v Fuel Transport (Pty) Ltd*<sup>111</sup> the court granted the applicant – a director – an interdict prohibiting shareholders from voting in support of a resolution for the removal of the applicant in contravention of a voting agreement that had

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<sup>106</sup> *Appel v Sher* 1950 (2) SA 224(W) 229

<sup>107</sup> MS Blackman, RD Jooste and GK Everingham et al op cit note 28 at 8 – 286

<sup>108</sup> HS Cilliers, ML Banade, JJ Henning et al *Corporate Law* 3ed (2000) 126

<sup>109</sup> *De Villiers v Jacobsdal Saltworks (Michaelis & De Villiers) (Pty) Ltd* 1959 (3) SA 873 (O) 874 at 877

<sup>110</sup> *Swerdlow v Cohen and Others* supra note 104 at 1057; See also *Stewart v Schwab and Others* 1956(4) SA 791 (T) at 793-794

<sup>111</sup> *Amoils v Fuel Transport (Pty) Ltd* 1978 (4) SA 343 (W)



been entered into between the shareholders.<sup>112</sup> In granting the interdict the court stated that:

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‘Section 220, in its terms, affords the company a statutory right to remove a director from its board notwithstanding an agreement between it and the directors to the contrary. It does not give those shareholders, who by contract have bound themselves to vote for the retention of the director in office the right to breach their agreement.’

In *Civils 2000 Holdings (Pty) Ltd v Black Empowerment Partner Civils 2000 (Pty) Ltd*<sup>114</sup> it was held that the plaintiff who held 70% of the shares in the company could not use its majority votes to remove two directors of the company because a provision in a shareholders’ agreement required 76% shareholder support to remove a director. Hence in the context of s 220(1) an agreement amongst shareholders could be used to prevent majority shareholders from using their vote to remove a director(s) from the board.<sup>115</sup>

Another means by which the removal of a director in terms of s 220(1) could be circumvented was the use of loaded voted rights. In *Bushell v Faith*<sup>116</sup> the House of Lords held that a provision of a company’s constitution which conferred loaded voting rights on the shareholders, who were also directors of the company, was valid and applicable despite the provisions of s 184(1) of the then English Companies Act 1948 – that section was the exact counterpart of s 220(1).

Loaded voting rights as a tool for circumventing a director’s removal in terms of s 220(1) only applied in the context of private companies; with regard to public companies there was no room for allocating weighted or loaded voting rights to certain shares or classes of shares because of the provisions of s 195(1) of the old Act.<sup>117</sup> Section 195(1) provided that:

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<sup>112</sup> Although the agreement was concluded between the shareholders, the court found that the agreement was in the nature of a contract for the benefit of the third party (*a stipulatio alteri*). And upon accepting appointment as a director in terms of the agreement, the applicant director had accepted the benefit of the contract thereby becoming a party to it. Accordingly, the court held that the director had *locus standi* to bring the application to enforce the contract.

<sup>113</sup> *Amoils v Fuel Transport (Pty) Ltd* supra note 111 at 347. See also *Desai and Others v Greyridge Investments (Pty) Ltd* 1974(1) SA 509 (A).

<sup>114</sup> *Civils 2000 Holdings (Pty) Ltd v Black Empowerment Partner Civils 2000 (Pty) Ltd* [2011] 3 All SA 215 (WCC)

<sup>115</sup> P Delpont *et al Henochsberg on the Companies Act 2008* note 46 at 270

<sup>116</sup> *Bushell v Faith* [1970] AC 1099 (HL). Although this is an English case a South African court, in *Swerdlow v Cohen and Others* supra note 104 at 184, discussed the case and noted that with regard to private companies there is no difference in general principle between English and South African law in relation to a situation such as occurred in *Bushell v Faith*.

<sup>117</sup> *Swerdlow v Cohen and Others* op cit note 104 at 184

A member of a public company having a share capital shall-

- (a) if the share capital is divided into shares of par value, be entitled to that proportion of the total votes in the company which the aggregate amount of the nominal value of the shares held by him bears to the aggregate amount of the nominal value of all the shares issued by the company;
- (b) if the share capital is divided into shares of no par value, be entitled to one vote in respect of each share he holds.

Apart from removal in terms of s 220(1), it was also possible to remove a director in terms of s 219 by way of a court order declaring that director disqualified from serving as a director.<sup>118</sup>

### **6.6.3 Appointment/election of directors under the Companies Act 71 of 2008**

It appears that there are three ways in which one becomes entitled to serve as a director in terms of the new Act. Section 66(4)(a) provides that:

‘A company’s Memorandum of Incorporation-

(a) may provide for-

- (i) the direct appointment and removal of one or more directors by any person who is named in, or determined in terms of, the Memorandum of Incorporation;
- (ii) a person to be an *ex officio* director of the company as a consequence of that person holding some other office, title, designation or similar status, subject to subsection (5)(a); or
- (iii) the appointment or election of one or more persons as alternate directors of the company and...

Section 66(7) provides further that,

‘A person becomes entitled to serve as a director of a company when that person -

- (a) has been appointed or elected in accordance with this Part, or holds an office, title, designation or similar status entitling that person to be an *ex officio* director of the company, subject to subsection (5)(a); and
- (b) has delivered to the company a written consent to serve as its director.’

As will be shown below in the discussion on removal of directors, it would appear that the Act makes a distinction between ‘elected’ and ‘appointed’ directors and that this distinction has a bearing on how a director can be removed from office.<sup>119</sup> Although the Act does not define the terms ‘election’ or ‘appointment’ one can infer that the term ‘election’ is used in reference to a competitive voting process whereby shareholders choose from a pool of candidates the individual(s) who should serve as directors.<sup>120</sup>

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<sup>118</sup> See the discussion in para 6.2.4 above

<sup>119</sup> See the discussion on removal of directors in para 6.6.4.1 below

<sup>120</sup> Section 68(2)(a) provides that:

On the other hand, s 66(4)(a)(i) refers to the ‘*direct appointment* and removal of one or more directors by any person who is named in, or determined in terms of, the Memorandum of Incorporation’ (writer’s emphasis). Hence the term ‘appointment’ appears to refer to a process whereby one party who is named in the MOI designates a person or persons to be members of the board of directors and the person(s) so designated become directors without any poll being conducted. Usually a person is designated or directly appointed to be a director to represent the interests of the person(s) that appoint him to the board.

Section 66(4)(b) provides that the MOI of a profit company other than a state-owned company must provide for the election by shareholders of at least 50% of the directors and 50% of any alternate directors.<sup>121</sup> This means that it is possible that the other 50% of the board may be directly appointed by any person named in the MOI in terms of s 66(4)(a)(i). Since a company’s MOI may name any person it means that, for example, a shareholder or group of shareholders, an employee or even a director of the company may be given the power to directly appoint up to 50% of a company’s directors. The possibility that a director or directors of a company may have the power to appoint 50% of the board members is of concern especially if, as will be discussed below, s 71 is construed to mean that directors who are directly appointed by a person named in the MOI can only be removed by the person who appointed them.

## **6.6.4 Removal of directors in terms of the Companies Act 71 of 2008**

### **6.6.4.1 Removal by shareholders**

Section 71(1) of the new Act provides as follows:

‘Despite anything to the contrary in a company’s Memorandum of Incorporation or rules, or any agreement between a company and a director, or between any shareholders and a director, a director may be removed by an ordinary resolution adopted at a shareholders meeting by the persons entitled to exercise voting rights in an election of that director, subject to subsection (2).’

Prima facie s 71(1) appears to give shareholders control of the company by empowering them to remove directors without cause by means of an ordinary resolution of the shareholders.

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‘Unless the company’s Memorandum of Incorporation provides otherwise, in any election of directors *the election is to be conducted as a series of votes, each of which is on the candidacy of a single individual to fill a single vacancy, with the series of votes continuing until all vacancies on the board at that time have been filled...*’ (writer’s emphasis).

<sup>121</sup> Section 66(4)(b) of the new Act

Although the new Act allows companies to prescribe in their MOIs a threshold of votes higher than 50%<sup>122</sup> to pass an ordinary resolution, s 65(8) makes an exception with regard to the ordinary resolution required to remove a director. Hence a company may not increase the threshold of votes required to pass such a resolution beyond 50 % of the votes exercised on the resolution.<sup>123</sup> This indicates an intent on the part of the legislature to ensure that companies do not make it difficult to remove directors by prescribing in their MOIs prohibitively high threshold of votes required to remove a director.

Section 71(1) is similar to s 220(1)(a) of the old Act to the extent that it provides for the removal of directors by ordinary resolution of the shareholders, and also to the extent that the right to remove a director by ordinary resolution prevails over anything to the contrary in the company's MOI or rules, or between the company and the director concerned. However, it differs significantly from s 220(1)(a) with regard to its impact on an agreement between shareholders and a director precluding the shareholders from removing the director. As discussed earlier, the import of cases such as *Stewart v Schwab*<sup>124</sup> and *Amoils v Fuel Transport (Pty) Ltd*<sup>125</sup> was that under s 220(1)(a)<sup>126</sup>;

*'an agreement between the shareholders and a director not to remove the director from office was valid and enforceable, and a director was able to interdict or restrain the shareholders from voting for his or her removal as a director in breach of the shareholder agreement'* (writer's emphasis).

In contradistinction, s 71(1) provides for the removal of a director by ordinary resolution of the shareholders, 'despite anything to the contrary in...any agreement between a company and a director, or *between any shareholders and a director*' (writer's emphasis). Hence unlike s 220(1)(a) of the old Act, s 71(1) overrides any agreement between the shareholders and a director which seeks to preclude shareholders from removing the director.<sup>127</sup>

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<sup>122</sup> Section 65(8)(a) and (b)

<sup>123</sup> Section 65(8) read with s 65(7)

<sup>124</sup> *Stewart v Schwab* supra note 110

<sup>125</sup> *Amoils v Fuel Transport (Pty) Ltd* supra note 111

<sup>126</sup> FHI Cassim, MF Cassim, R Cassim op cit note 18

<sup>127</sup> FHI Cassim 'The division and balance of power between the board of directors and the shareholders: the removal of directors' (2013) 29 *Banking and Finance Law Review* 151 at 161; See also P Delpont *et al Henochsberg on the Companies Act 2008* op cit note 46 at 273

Like s 220(1)(a), s 71(1) does not refer to an agreement between shareholders to which a director is not a party.<sup>128</sup> As observed earlier, in the context of s 220(1)(a) the court ruled that an agreement between shareholders not to vote for the removal of a director was valid and binding.<sup>129</sup> It would appear that such an agreement between shareholders would also be valid and binding under s 71(1)<sup>130</sup> because the section does not refer to an agreement between shareholders. A question that arises is whether an agreement between shareholders not to vote for the removal of a director could be invalidated in terms of s 15(7) for being inconsistent with the Act.<sup>131</sup> Section 15(7) of the new Act provides that:

‘The shareholders of a company may enter into any agreement with one another concerning any matter relating to the company, but any such agreement must be consistent with this Act and the company’s Memorandum of Incorporation, and any provision of such an agreement that is inconsistent with this Act or the company’s Memorandum of Incorporation is void to the extent of the inconsistency’

It seems unlikely that an agreement between shareholders not to vote for the removal of a director could be invalidated under s 15(7) for being inconsistent with the Act. It is submitted that such an agreement is not inconsistent with the Act because s 71(1) of the Act does not bring such agreements within its scope. If the legislature intended such shareholders’ agreements to be invalid under the new Act, it would have ensured that s 71(1) expressly overrides them.

Another concern that has been raised is whether a shareholder’s agreement that precludes shareholders from voting for the removal of a director could also possibly be nullified in terms of the anti-avoidance provisions of s 6(1) of the new Act.<sup>132</sup> Section 6(1) empowers a court to declare *inter alia*, any agreement to be primarily or substantially intended to defeat or reduce the effect of a prohibition or requirement established by or in terms of an unalterable provision of the Act and to declare that agreement void to that extent. However, Ncube argues, and it is submitted rightly so, that a shareholder’s agreement that thwarts removal of directors by shareholders is unlikely to be subject to s 6(1).<sup>133</sup> She argues that s 6(1) applies to *inter alia*, agreements that seek to defeat or minimise the effect of an

<sup>128</sup> FHI Cassim ‘The division and balance of power’ op cit note 127 at 159; See also C Ncube ‘You’re fired! the removal of directors under the Companies Act 71 of 2008’ (2011) 128 *SALJ* 33 at 38

<sup>129</sup> *Stewart v Schwab* supra note 110 at 793

<sup>130</sup> P Delport *et al Henochsberg on the Companies Act 2008* op cit note 46 at 273; See also FHI Cassim, MF Cassim, R Cassim *et al* op cit note 32 at 441; C Ncube op cit note 128 at 38

<sup>131</sup> FHI Cassim ‘The division and balance of power’ op cit note 127 at 161.

<sup>132</sup> *Ibid* at 164

<sup>133</sup> C Ncube op cit note 128 at 38

unalterable prohibition or requirement and that s 71(1) does not contain an unalterable prohibition or requirement.

It is submitted that the right of shareholders to remove a director in terms of s 71(1) is also weakened by the fact that the new Act permits loaded voting rights.<sup>134</sup> Section 37(2) provides that each issued share of a company, regardless of its class, has associated with it one general voting right, except to the extent provided otherwise by the Act or the preferences, rights, limitations and other terms determined by or in terms of the company's MOI in accordance with section 36. Section 37(5)(a) also provides that subject to any other law, a company's MOI may establish, for any particular class of shares, preferences, rights, limitations or other terms that confer special, conditional or limited voting rights. It is significant to note that while the old Act prohibited loaded voting rights in respect of public companies, the new Act permits them in both private and public companies. Hence the decision in *Bushell v Faith*<sup>135</sup> will have a wider impact than before.

It is noteworthy that where it is proposed to remove a director in terms of s 71(1) the Act requires that the director concerned be given notice of the meeting and the resolution and, he/she must be afforded a reasonable opportunity to make a presentation to the meeting before the resolution is put to the vote.<sup>136</sup>

Section 71 appears to have been influenced by equivalent provisions found in corporate legislation in foreign jurisdictions. For instance, s 109(1) of the Canada Business Corporations Act empowers shareholders in general meeting to remove directors by ordinary resolution. Similarly, in the USA s 8.08(a) of the Model Business Corporations Act empowers shareholders in general meeting to remove directors but this right is restricted by s 8.08(b) which provides that, 'If a director is elected by a voting group of shareholders, only the shareholders of that voting group may participate in the vote to remove him.'

Although s 71(1) appears to empower shareholders, it is submitted that the section suffers from an ambiguity which potentially limits the right of shareholders to remove directors. Based on the language of s 71(1) one could conclude that only the shareholders who are entitled to vote in an election of a particular director are entitled to participate in the voting process to remove that director. This is because s 71(1) provides that 'a director may

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<sup>134</sup> FHI Cassim 'The division and balance of power' op cit note 127 at 164

<sup>135</sup> *Bushell v Faith* supra note 116. For a discussion of the facts of this case see paragraph 6.6.2 above

<sup>136</sup> Section 71(2)(a) and (b)

be removed by an ordinary resolution adopted at a shareholders meeting by the persons entitled to exercise voting rights in an election of that director...' Moreover, the language in the section appears to preclude the removal of an appointed director by means of an ordinary resolution of the shareholders.<sup>137</sup> This is because such a director is not 'elected.' Cassim<sup>138</sup> rightly notes that,

'On a strict interpretation of section 71 if a director has been directly appointed to the board of directors by other directors, the shareholders do not have the power any more to remove such director from office by ordinary resolution.'

The view has also been advanced to the effect that a director who is appointed – as opposed to being elected – could also be removed by means of an ordinary shareholders' resolution.<sup>139</sup> This view is based on the argument that any provision in a MOI which confers exclusive power to remove a particular director on a person named in the MOI pursuant to s 66(4)(a)(i) would be overridden by the words, 'despite anything to the contrary in a company's Memorandum of Incorporation or rules, or any agreement between a company and a director, or between any shareholders and a director, a director may be removed by an ordinary resolution..' contained in s 71(1).<sup>140</sup> However, the correctness of this argument is debatable because s 71(1) refers to removal by 'an ordinary resolution adopted at a shareholders meeting *by the persons entitled to exercise voting rights in an election of that director.*' (writer's emphasis). This begs the question how does this apply to a director who was directly appointed by a person who is named in the MOI in terms of s 66(4)(a)(i). For such a director is not elected by any of the company's shareholders, therefore there can be no question of there being persons entitled to exercise voting rights in an election of that director.

It is submitted that there appears to be no cogent reason why in principle shareholders should be precluded from removing, by ordinary resolution, a director appointed in terms of s 66(4)(a)(i). Perhaps a plausible argument that could be raised against this submission would be that a director appointed pursuant to s 66(4)(a)(i) is usually a representative director who is expected to represent the interests of the appointing party on the company's board;<sup>141</sup>

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<sup>137</sup> C Ncube op cit note 128 at 38; C Stein and G Everingham op cit note 82 and P Delpont *The New Companies Act Manual* 2ed (2011) at 81

<sup>138</sup> FHI Cassim 'The division and balance of power' op cit note 127 at 160.

<sup>139</sup> FHI Cassim, MF Cassim, R Cassim *et al* op cit note 32 at 442-443. See also FHI Cassim 'The division and balance of power' op cit note 127 at 157-158

<sup>140</sup> FHI Cassim, MF Cassim, R Cassim *et al* *ibid*

<sup>141</sup> Institute of Directors of South Africa *Representative directors: Directors expected to represent the interests of the appointing party* Position Paper No. 4 (2011) Available at

therefore only the appointing party should have the power to remove that director. For example, it is conceivable that a company's MOI may give a major creditor, bank or lender to the company the right to appoint a director to represent the interests of that institution on the company's board.<sup>142</sup> Hence allowing shareholders in general meeting to remove such a representative by ordinary resolution would prejudice the interests of the appointing party. However, it is submitted that the interests of the appointing party must be viewed in the light of the principle that a director who is appointed by a particular person is not the servant or agent of that appointing party; and, while he may represent the interests of the appointing party, he is in law obliged to serve the best interests of the company to the exclusion of the interests of the appointing party when carrying out his duties as a director.<sup>143</sup> Therefore since his primary duty is to serve the interests of the company there is no reason in principle why the shareholders in general meeting – acting for the company – should be precluded from removing the director. Moreover, such an appointed director could in any event still be removed, in the case of a company with more than two directors, by the board<sup>144</sup> or, in the case of a company with less than three directors, by the Companies Tribunal.<sup>145</sup> If it is possible for an appointed director to be removed in this fashion by parties other than the appointing party, there is no reason why shareholders in general meeting should be precluded from removing an appointed director in terms of s 71(1). This appears to be an unwarranted restriction of the shareholders' right to remove directors.

It is submitted that, if the objective of denying shareholders the right to remove an appointed director by ordinary resolution was to protect the interests of the appointing party then, there is a better way of achieving this without compromising the shareholders' right to remove directors. For instance, s 71(1) could have been modelled on s 203D(1) of the Australian Corporations Act 2001 which provides that,

‘a public company may by resolution remove a director from office despite anything in the company's constitution or an agreement between the company and the director, or an agreement between any or all members of the company and the director.’<sup>146</sup>

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[https://c.ymcdn.com/sites/www.iodsa.co.za/resource/collection/05E93ACB-10BE-4507-9601-307A66F34BD8/CGN\\_Position\\_Paper\\_4\\_Representative\\_Directors.pdf](https://c.ymcdn.com/sites/www.iodsa.co.za/resource/collection/05E93ACB-10BE-4507-9601-307A66F34BD8/CGN_Position_Paper_4_Representative_Directors.pdf) accessed 23 May 2016

<sup>142</sup> Ibid

<sup>143</sup> *Fisheries Development Corporation of SA Ltd vs Jorgensen and Another; Fisheries Development Corporation of SA Ltd vs AWJ Investments (Pty) Limited and Others* 1980 (4) SA 156 (W) at 158-164

<sup>144</sup> Section 71(3)

<sup>145</sup> Section 71(7)

<sup>146</sup> Section 203D(1)(a), (b) and (c) of the Australia Corporations Act 2001



Section 203D(1) makes no distinction between elected and appointed directors. Hence shareholders in Australian public companies have the power to remove representative directors appointed by a particular party. Further, with regard to representative directors, section 203D(1) protects the interests of the appointing party by providing that,

‘If the director was appointed to represent the interests of particular shareholders or debenture holders, the resolution to remove the director does not take effect until a replacement to represent their interests has been appointed.’

Modelling our s 71(1) along the lines of s 203D(1) would ensure that shareholders would not only have power to remove elected directors, but also ex officio directors as well as directors directly appointed by parties named in the MOI. A narrow interpretation of s 71(1) read with s 66(4)(a)(i) would be a fundamental departure from the position under the old Act. There was no provision in the old Act to the effect that only the party who appointed a director could remove that director. Hence it did not matter then whether a director was elected or directly appointed by a particular party – shareholders could remove any director by ordinary resolution in terms of s 220(1).

Denying shareholders the power to remove directors appointed in terms of s 66(4)(a)(i) would be incongruent with current trends in corporate law where the right of shareholders to remove all, or any of the directors, by ordinary resolution at any time and, for any reason, is considered a powerful tool to make the board accountable.<sup>147</sup> It would set South Africa apart from other jurisdictions such as America, Canada, Australia and the United Kingdom because none of these jurisdictions curtails the shareholders’ power to remove directors in the manner which s 71(1) read with s 66(4)(a)(i) appears to do.<sup>148</sup> Hence a strict interpretation of these provisions would frustrate the realisation of one of the objectives of the law reform process namely, to harmonise South African law with the law in other best practice jurisdictions.<sup>149</sup>

#### **6.6.4.2 Removal by the board**

Apart from removal by shareholders, the new Act also provides for the removal of directors by the board of directors in terms of s 71(3). Section 71(3) provides as follows:

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<sup>147</sup> PL Davies ‘The board of directors: composition, structure, duties and powers’ A conference paper delivered at a *Conference on Company Law Reform in OECD Countries: A Comparative Outlook of Current Trends*, (2000) Stockholm, Sweden, Available at <http://www.oecd.org/daf/ca/corporategovernanceprinciples/1857291.pdf> accessed 1 March 2016

<sup>148</sup> FHI Cassim ‘The division and balance of power’ op cit note 127 at 161; C Ncube op cit note 128 at 38

<sup>149</sup> DTI Policy paper op cit note 48 at 11

If a company has more than two directors, and a shareholder or director has alleged that a director of the company-

(a) has become-

(i) ineligible or disqualified in terms of section 69, other than on the grounds contemplated in section 69(8)(a); or

(ii) incapacitated to the extent that the director is unable to perform the functions of a director, and is unlikely to regain that capacity within a reasonable time; or

(b) has neglected, or been derelict in the performance of, the functions of director, the board, other than the director concerned, must determine the matter by resolution, and may remove a director whom it has determined to be ineligible or disqualified, incapacitated, or negligent or derelict, as the case may be.

Section 71(3) is a novel provision in that it, for the first time in South Africa, gives the board of directors statutory power to remove a director.<sup>150</sup> The old Act did not confer power on the board to remove directors. Rather s 220(7) of the old Act left it open for companies to choose whether or not they wanted to empower their directors, via a provision in the articles, to remove a director from office.<sup>151</sup> Section 220(7) of the old Act provided *inter alia* that ‘nothing in this section shall be construed as...derogating from any power to remove a director which may exist apart from this section.’

Removal in terms of s 71(3) can only be carried out on the grounds specified in paragraphs (a) and (b) of that section. In other words, removal by the board must be for cause. This contrasts with the removal by shareholders in terms of s 71(1) where the removal can be without cause.<sup>152</sup>

Unlike the shareholder’s power to remove a director in terms of s 71(1), the board’s removal power is not restricted to elected directors only.<sup>153</sup> It extends to all categories of directors, whether they are directly appointed by a person named in the MOI, elected by shareholders or they are ex-officio directors.

The board’s removal power is significant especially if it is considered in the light of s 66(4)(a)(i) in terms of which the MOI of a company may empower, *inter alia*, the board to appoint up to 50% of the board members. Therefore, s 71(3) read with s 66(4)(a)(i)

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<sup>150</sup> Ibid; See also C Stein and G Everingham *op cit* note 82 at 233

<sup>151</sup> MS Blackman, RD Jooste, GK Everingham *et al* *op cit* note 28 at 8-284

<sup>152</sup> In terms of the procedure, s 71(4) of the Act requires that before the board may consider a resolution to remove a director, it must give the director concerned notice of the meeting, including a copy of the proposed resolution and a statement setting out the reasons for the resolution, with sufficient specificity to reasonably permit the director to prepare and present a response. The director concerned must also be given an opportunity to make a presentation to the meeting before the resolution is put to the vote.

<sup>153</sup> FHI Cassim ‘The division and balance of power’ *op cit* note 127 at 162

potentially shifts the balance of power in favour of the board at the expense of shareholders. As Cassim,<sup>154</sup> commenting on the director removal provisions in s 71, says:

“These entirely innovative statutory provisions have taken away from shareholders their sole privilege to remove a director from office. Section 71(3) is not only unique, but also flouts the important principles of the Organisation for Economic Co-operation and Development (2004) that state categorically that the election and the removal of directors must be treated as a ‘basic shareholder right.’”

Concern has been expressed that giving the board of directors power to dismiss one of their own could inhibit free and open debate on the board; fear of removal may cause directors to be wary about expressing their views on a particular issue, especially if their view is opposed to the majority view on the board.<sup>155</sup> However, it must be noted that in the event of directors holding different views concerning a particular matter the majority view generally prevails.<sup>156</sup> In view of this Knight<sup>157</sup> rightly states that,

‘It is difficult to see what incentive exists for directors in the majority on a particular issue to rid themselves of a minority director when that director is not in a position to obstruct the workings of the board or to frustrate the will of the majority of directors.’

It is also submitted that the Act adequately protects directors<sup>158</sup> from unwarranted removals by the board hence directors should be able to freely express their views on the board without fear of removal.

Notwithstanding the above, this writer is of the view that giving the board power to remove a director could potentially lead to boardroom battles that destabilise the company and attract negative publicity regarding a company’s internal governance matters. This is especially so in the context of removals by the board in terms 71(3) where the board’s decision may end up being the subject of court proceedings pursuant to s 71(5). Recently the media reported on a boardroom battle at a JSE listed mining company involving two directors who were removed by the board for alleged corporate governance breaches.<sup>159</sup> Subsequent to the removal some shareholders requisitioned a shareholders’ meeting and, at the resulting meeting shareholders re-appointed the two directors who had been removed by the board and,

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<sup>154</sup> Ibid

<sup>155</sup> Ibid

<sup>156</sup> See section 73(5)(d) of the Act

<sup>157</sup> S Knight ‘The removal of public company directors in Australia: time for change?’ (2007) 25 *Company and Securities Law Journal* 351 at 361

<sup>158</sup> A director removed by the board for dissent can apply for a review of the board’s decision in terms of s 71(5). Section 163 also provides the director with a remedy against oppressive or unfairly prejudicial conduct.

<sup>159</sup> See C Mathews ‘Wesizwe faces stormy meeting to elect directors’ Business Day 17 December 2009 available at <http://www.bdlive.co.za/articles/2009/12/17/wesizwe-faces-stormy-meeting-to-elect-directors> accessed 8 April 2016

they simultaneously removed some of the directors who had participated in the decision to remove the two directors.<sup>160</sup> It is submitted that s 71(3) could potentially lead to situations such as this where the board's removal power may result in unnecessary boardroom battles that unsettle the company.

It is submitted that the question whether a board should have power to remove a director is a matter that should have been left for companies to decide on their own by inserting appropriate provisions in their MOI. This would have given companies the flexibility to order their internal corporate governance procedures in the manner they see fit. Section 220(1) read with s 220(7) of the old Act provided such flexibility. As it is, by making s 71(3) an unalterable provision the legislature has made this the default position for both public and private companies. This one size fits all approach may not be appropriate for some companies.

The board's statutory power to remove directors in terms of 71(3) appears to set South Africa apart from other jurisdictions. For instance, in Australia the position with regard to public companies is that directors can be removed by the shareholders in terms of s 203D of the Australian Corporations Act 2001. Section 203E further provides that,

A resolution, request or notice of any or all of the directors of a public company is void to the extent that it purports to:

- (a) remove a director from their office; or
- (b) require a director to vacate their office.

Hence in Australia only shareholders can remove directors of public companies and board removals are expressly prohibited.<sup>161</sup> It is interesting to note that the Australian Institute of Company Directors (AICD) expressed strong support for this position with regard to public companies.<sup>162</sup>

In the United Kingdom a director may be removed by ordinary resolution before the expiration of his period of office, notwithstanding anything in any agreement between the

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<sup>160</sup> Ibid. See also 'WEZ - Wesizwe Platinum Limited - Update To Shareholders' 18 February 2010, an announcement posted by Wesizwe Platinum Limited on the Stock Exchange News Service (SENS) available at <http://196.30.126.229/%5Csensad.asp?id=150053> accessed 8 April 2016

<sup>161</sup> Directors of proprietary companies may be removed by ordinary resolution in terms of the replaceable rule contained in s 203C. It is possible that the constitution of a proprietary company may provide for the removal of directors by the board.

<sup>162</sup> Australian Institute of Company Directors (AICD) Position paper No.6 (2007) available at <http://www.companydirectors.com.au/~media/resources/director-resource-centre/policy-on-director-issues/2007/position-paper-no6--director-resignations-and-removals.ashx?la=en> Accessed on 14 March 2016

company and the director.<sup>163</sup> The UK Companies Act 2006 does not give the board statutory power to remove directors. However, s 168(5)(b) of the UK Companies Act permits companies to provide for other ways of removing directors other than what is provided for in the Act. Hence it is possible that the articles of a company could provide for board removals.

In the USA the Model Business Corporations Act which, as observed earlier, has been adopted by most states, provides that the shareholders may remove one or more directors with or without cause unless the articles of incorporation provide that directors may be removed only for cause.<sup>164</sup> There is no provision in the Model Business Corporations Act granting the board power to remove directors. In Delaware the general position is that any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors.<sup>165</sup> The General Corporation Law of Delaware does not give the board power to remove directors. On the other hand, the California Corporations Code, apart from providing for removal of directors by shareholders, also provides that ‘the board may declare vacant the office of a director who has been declared of unsound mind by an order of court or convicted of a felony.’<sup>166</sup>

Although the California Corporations Code gives the board power to remove a director, it is submitted that this power is less of a concern than the power given to the board in terms of s 71(3) of the new Act. This is because the power of the board under the California Corporations Code relates to situations that are straightforward and therefore unlikely to give rise to any disputes as to whether the board’s decision was right or wrong. The circumstances in which the power may be exercised do not require the board to exercise its own judgment, rather the board’s decision follows on a court order declaring the director in question to be of unsound mind or, upon a court convicting the director of a felony. By contrast a board deciding whether or not remove a director in terms of s 71(3)(a)(ii), or 71(3)(b) would have to evaluate the facts and come to its own judgment concerning whether the director in question is incapacitated to the extent that he/she is unable to perform the functions of a director, and is unlikely to regain that capacity within a reasonable time or,

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<sup>163</sup> Section 168(1) of the UK Companies Act 2001

<sup>164</sup> Model Business Corporations Act s 8.08(a)

<sup>165</sup> Section 141(k) of the General Corporation Law of Delaware

<sup>166</sup> Section 302 of the California Corporations Code (2004)

whether in fact the director has neglected, or been derelict in the performance of the functions of a director respectively.

#### **6.6.4.3 Removal by the tribunal**

Section 71(8) is another novel provision of the Act which provides for the removal of directors by the Tribunal in the case of companies with less than three directors. Removal by the Tribunal does not apply to public companies because they are required to have at least three directors.<sup>167</sup> In terms of s 71(8)(b) the Tribunal may remove a director on grounds similar to those applicable in the case of board removals. Hence removals by the Tribunal are for cause. Removals by the Tribunal also take place at the instance of a shareholder or a director of the company.<sup>168</sup>

It is important to note that s 71(8) makes no distinction between appointed or elected directors. This is important because, as noted earlier, it would seem that it is not possible to remove an appointed or an ex-officio director by ordinary resolution of the company's shareholders. Therefore, s 71(8) offers shareholders an indirect way of removing appointed directors. The only drawback from a shareholder's perspective is that such removals may only be effected on the specific grounds specified in the Act. Moreover, removals by the Tribunal are reviewable by the court.<sup>169</sup>

#### **6.6.5 Directors' remedies consequent to removal**

It is important to note that while s 71(3) empowers shareholders to remove directors at any time before the expiration of their terms, the director concerned may, depending on the circumstances of the case, claim damages for breach of contract against the company as per s 71(9) of the Act. Section 71(9) provides that:

Nothing in this section deprives a person removed from office as a director in terms of this section of any right that person may have at common law or otherwise to apply to a court for damages or other compensation for-

- (a) loss of office as a director; or
- (b) loss of any other office as a consequence of being removed as a director

Under the old Act a director who had been removed from office before the expiration of his term of office had a claim for damages against the company only if he had a fixed term

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<sup>167</sup> Section 66(2)(b) of the new Act

<sup>168</sup> Section 71(8)(b) of the new Act

<sup>169</sup> Section 71(5) & (8)(c) of the new Act

contract of service with the company whereby the company contracted to compensate him or not to terminate his office and, if he had not breached the contract entitling the company to terminate it.<sup>170</sup> In the absence of a separate fixed term contract with the company the director could not rely on the fact that he assumed the office of a director on the terms contained in the articles of association; the reason for this is that the articles do not constitute a contract between a company and a director in his capacity as such.<sup>171</sup>

Interestingly, it would appear that under the new Act a director does not need to have a separate service contract with the company in order to have a claim for damages for removal from office as a director or, for loss of any other office as a result of being removed as a director.<sup>172</sup> This is a result of s 15(6) which provides that the MOI is binding inter alia between the company and each director. Hence a MOI constitutes a contract between the company and a director with the consequence that if the director is removed from office he may be able to base his claim for damages on a breach of the terms of the MOI. This is yet another instance of the new Act giving directors rights that they did not have before. The ability to bring a claim for damages helps the director to entrench himself in office and, the fact that there no longer has to be a separate service contract further enhances a director's ability to entrench himself.

### **6.6.6 Does section 71 constitute an exclusive code?**

The foregoing discussion has shown that s 71 provides for three modes of director removals.<sup>173</sup> The section also prescribes the procedure to be followed in each case. It is noteworthy that the new Act does not have a provision equivalent to s 220(7) of the old Act, which permitted companies to set out in their constitutions procedures for the removal of directors as an alternative to the procedure provided for in s 220(1).<sup>174</sup> Where a company's constitution established such an alternative procedure shareholders had an election to follow that procedure rather than the one set up in s 220 of the Act.<sup>175</sup> The absence of a provision similar to s 220(7) in the new Act raises the question whether it would be permissible for a company to set out in its MOI a procedure for the removal of directors as an alternative to the

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<sup>170</sup> MS Blackman, RD Jooste, GK Everingham *et al* op cit note 28 at 8-286

<sup>171</sup> *De Villiers v Jacobsal Saltworks (Michaelis & De Villiers) (Pty) Ltd* supra note 109 at 876-7

<sup>172</sup> FHI Cassim, MF Cassim, R Cassim *et al* op cit note 32 at 452

<sup>173</sup> Section 71(1); (3) and (8) respectively

<sup>174</sup> MS Blackman, RD Jooste, GK Everingham *et al* op cit note 28 at 8-285. See also HS Cilliers, ML Benade, JJ Henning *et al* op cit note 108 at para 9.32

<sup>175</sup> MS Blackman, RD Jooste, GK Everingham *et al* op cit note 28

procedures in s 71. In other words, the question is whether s 71 constitutes an exclusive code for removing directors?

This question is of practical importance as can be seen in the Australian experience where courts have come up with conflicting decisions in relation to the procedural requirements set by s 203D of the Australian Corporations Act 2001.<sup>176</sup> Section 203D is the equivalent of, and its wording is similar to the wording in s 71(1) of the new Act. It provides that a public company may by resolution remove a director from office at any time despite anything that may be found in the company's constitution, an agreement between the company and the director, and an agreement between the members and the company. Like its South African counterpart, s 203D prescribes the procedure to be followed in such a removal. This includes inter alia the requirement that a notice of intention to move the resolution to remove the director must be given to the director concerned.<sup>177</sup> Further, the director concerned is entitled to put his case to the members by giving the company a written statement for circulation to members and to speak to the motion at the meeting.<sup>178</sup>

In the case of *Scottish & Colonial Ltd -v- Australian Power and Gas Co Ltd*<sup>179</sup> one of five directors of a listed public company called a shareholders' meeting to consider a resolution to remove the other four directors and appoint one other. The director did not follow the procedure stipulated in s 203D of the Corporations Act. The company's constitution provided for the removal of directors by a shareholders' resolution, but it did not contain any procedural requirements similar to those in s 203D. The court held that compliance with s 203D was necessary and made an order restraining the company from considering the resolution to remove the directors. In arriving at its decision the court noted that s 203D was different from the previous legislation which had consistently been interpreted by the courts as allowing companies to proceed in accordance with either the legislation or with provisions in their articles regulating removal of directors. It noted that the language used in s 203D was clear and that the use of the words 'despite anything' in s 203D (1) emphasized the attainment of the purpose that directors be given an opportunity to put their case to the members when removal is proposed.

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<sup>176</sup> A Jaque and L Golchin, 'Australia: You're Fired! - Dealing with the Removal of Directors from the Board,' available at

<http://www.mondaq.com/australia/x/71638/Directors+Officers/Youre+Fired+Dealing+With+The+Removal+Of+Directors+From+The+Board>, accessed 13 October 2014.

<sup>177</sup> Section 203D(3) of the Australian Corporations Act 2001

<sup>178</sup> Section 203D(4) of the Australian Corporations Act 2001

<sup>179</sup> *Scottish & Colonial Ltd -v- Australian Power and Gas Co Ltd* supra note 94



Given that s 203D of the Australian Corporations Act 2001 is similar to s 71 of the new Act it is possible that South African courts may follow the decision in *Scottish & Colonial Ltd -v- Australian Power and Gas Co Ltd* pursuant to s 5(2) which allows the courts to consider foreign law when interpreting the Act. It must be pointed out that there are other decisions of the Federal Court of Australia and the Supreme Court of Western Australia<sup>180</sup> that interpret section 203D differently to *Scottish & Colonial Ltd* by holding that the statutory procedures are not mandatory. Notwithstanding these other contrary decisions, it is submitted that South African courts are likely to follow the *Scottish & Colonial Ltd* decision for the reasons discussed below.

First, it must be remembered that s 71 is an unalterable provision. And, s 15(2)(d) of the new Act prohibits the inclusion in a company's MOI of any provision that negates, restricts, limits, qualifies, extends or otherwise alters the substance or effect of an unalterable provision of the Act. Hence it is submitted that the validity of a provision in the MOI that establishes an alternative procedure for the removal of directors would be questionable, particularly if the provision in the MOI does not incorporate the requirements set out in s 71 such as, in the case of a removal by shareholders, the giving of notice to the director concerned and, also affording the director an opportunity to address the shareholders' meeting.<sup>181</sup> Such a provision in the MOI would be invalid because it negates or alters the substance and effect of s 71 which is an unalterable provision. Furthermore, such a provision would be inconsistent with s 71 and consequently void in terms of s 15 (1) which requires that each provision of a company's MOI must be consistent with the Act otherwise the provision would be void to the extent that it is inconsistent with the Act.

It must be noted though that s 15(2)(a)(iii) read with s 15(2)(d) contemplate that a provision may be included in a company's MOI which, amongst other things, qualifies, extends or otherwise alters the substance or effect of an unalterable provision of the Act.<sup>182</sup> However such a provision may only be included in the MOI if it meets the requirement of imposing on the company a higher standard, greater restriction, longer period of time or any similarly more onerous requirement, than would otherwise apply to the company in terms of the unalterable provision.<sup>183</sup> A provision in the MOI providing for the removal of elected directors without the need for a shareholder's resolution or, without giving notice to the

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<sup>180</sup>*Central Exchange Ltd -v- Rivkin Financial Services Ltd* (2004) 213 ALR 771; *Allied Mining & Processing Ltd -v- Boldbow Pty Ltd* (2002) 26 WAR 355; [2002] WASC 195; BC200204511; See A Jaque and L Golchin op cit note 176

<sup>181</sup> Section 71(2)(a) and (b)

<sup>182</sup> See the discussion in para 3.3.4 of chapter 3.

<sup>183</sup> Section 15(2)(a)(iii) of the new Act

director concerned or, without giving the director an opportunity to address the shareholders as required by s 71 can hardly be said to impose a higher standard or more onerous requirement on the company. It would therefore appear, in the light of the above, that the requirements of s 71 are mandatory and, that a provision in a company's MOI which establishes an alternative procedure for the removal of elected directors that does not incorporate the requirements of s 71 would be invalid.

It is unfortunate that the new Act does not have a provision equivalent to s 220(7) of the old Act that would enable companies to include provisions in their MOI establishing alternative procedures for the removal of directors. It is not clear whether the legislature's failure to include in the new Act a provision similar to s 220(7) of the old Act was a mere oversight or, it was a well-considered policy decision. Inclusion of a provision similar to s 220(7) would have given shareholders the choice, when removing directors, to either proceed in terms of the statutory procedure set in s 71 of the new Act or in terms of the procedure set in the MOI. As argued above, it is likely that the courts will find that the requirements of s 71 are mandatory and thus effectively precluding the possibility that a company's MOI could provide for an alternative removal procedure giving shareholders the freedom of choice as to which procedure to follow. It is submitted that the shareholders power to remove directors is such an important accountability tool that it should be made available with very limited, if any, restrictions.

## **6.7 Shareholder apathy**

In discussing how the new Act has changed the balance of power between shareholders and directors and how this impacts on corporate governance, especially the protection of shareholders, the issue of shareholder apathy bears consideration. For if shareholders do not make effective use of the power given to them by the Act this would not enhance corporate governance or improve the protection of shareholders. The problem of shareholder apathy or passivity, especially in companies with widely dispersed shareholding, has been a topical issue locally and abroad.<sup>184</sup> The discussion below briefly highlights some of the reasons for shareholder apathy and how the new Act attempts to encourage shareholder activism.

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<sup>184</sup> See C Rademeyer and J Holtzhausen 'King II, Corporate Governance and Shareholder Activism' (2003) 120 *SALJ* 767; I Esser and M Havenga 'Shareholder participation in corporate governance.' (2008) 1 *Speculum Juris* 74; *King Report on Corporate Governance for South Africa* (2002) King Committee on Corporate Governance; LM. Fairfax 'Shareholder democracy on trial: international perspective on the effectiveness of increased shareholder power' (2008) *Virginia Law and Business Review* 1; SM Bainbridge 'Director primacy and shareholder disempowerment' op cit note 101 at 1735

Some of the reasons that have been advanced<sup>185</sup> to explain why shareholders take a passive role in corporate governance include the following: that shareholders are not aware of their rights; that shareholders do not appreciate the influence they can have on corporate governance and they believe that their efforts would not bear meaningful results; the prohibitive costs of monitoring compliance with corporate governance principles – these include costs of attendance at meetings and litigation costs; lastly, shareholders are only interested in the return on their investment in a company and they are not really concerned about corporate governance issues – if a company ceases to yield the expected return the shareholders will simply sell their shares. Some of these reasons are generalised of course and therefore do not apply universally to all shareholders. For instance, while some unsophisticated individual shareholders may not be aware of their rights and powers as shareholders, institutional investors would be aware given that they are professional investors.<sup>186</sup> Moreover while the issue of the costs involved in monitoring compliance with corporate governance principles could be significant for individual shareholders it might not be of great consequence for institutional investors.

In 2002 the *King Report on Corporate Governance for South Africa* (hereafter the King II Report) noted the critical role played by shareholder activism in encouraging good corporate governance.<sup>187</sup> The King II Report made a number of recommendations on how to encourage shareholder activism. These included educating shareholders on corporate governance.<sup>188</sup> Undoubtedly this education drive would benefit the individual and unsophisticated shareholder. It also recommended that ‘institutional investors should be more transparent in their dealings with companies, and should be encouraged to demand the highest governance standards.’<sup>189</sup>

To address the perceived high costs of monitoring and enforcing compliance with corporate governance regulations the King II Report recommended the introduction of class actions and a contingency fees system.<sup>190</sup> With regard to the problem of low attendances at shareholders’ meetings the Report recommended that quorum requirements for ordinary resolutions be increased to at least 25% of the total shares in issue having voting rights.<sup>191</sup>

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<sup>185</sup> See I Esser and M Havenga op cit note 184 at 78; See also C Rademeyer and J Holtzhausen op cit note 184 at 768-769

<sup>186</sup> FHI Cassim, MF Cassim, R Cassim et al op cit note 32 at 499

<sup>187</sup> See section 6, chapter 6 of the *King Report on Corporate Governance for South Africa* (2002) King Committee on Corporate Governance.

<sup>188</sup> King II s 6, Chapter 6 paras 2 and 4

<sup>189</sup> King II Recommendations which follow after para 4 of Chapter 8

<sup>190</sup> King II s 6, Chapter 3 paras 5 and 6

<sup>191</sup> King II Recommendation 7 under ‘Recommendations requiring statutory amendment and other actions.’

The rationale for increasing the quorum requirements for shareholders' meetings is that, 'this would encourage companies to solicit attendance at meetings or receipt of proxies and highlight the need for shareowners to give due consideration to the use of their votes.'<sup>192</sup>

A problem with this recommendation is that shareholder apathy could make it difficult for companies to conduct shareholders' meetings if they could not get the required number of shareholders to attend the meeting. It is significant that the King Committee acknowledged at the time that 'considerable public comment was received suggesting that this recommendation was both impractical and unduly onerous.'<sup>193</sup>

Another criticism of the recommendation to increase the quorum for shareholders' meetings is that this would not guarantee good corporate governance because the board members were likely to lobby for the attendance of only those shareholders who are friendly to the board, and therefore unlikely to ask difficult questions.<sup>194</sup> Moreover, even if shareholders could be persuaded to attend the meetings, there is no guarantee that they would undertake due diligence research concerning the governance of the company or, that they would commit to monitoring managerial actions on a continuing basis, especially if such shareholders perceived their shareholding as too small to warrant any active involvement beyond attendance at meetings.<sup>195</sup> Hence increasing quorum requirements without more only addresses the quantitative aspect of shareholder activism – attendance at shareholders' meetings without addressing the qualitative aspect of informed, and pro-active shareholder engagement on matters impacting on corporate governance.

The new Act appears to have heeded the King Committee's recommendation to increase quorum requirements for shareholders' meetings. Section 64(1)(a) provides that a shareholders meeting may not begin until sufficient persons are present at the meeting to exercise, in aggregate, at least 25 percent of all of the voting rights that are entitled to be exercised in respect of at least one matter to be decided at the meeting. This contrasts with s 190 of the old Act which prescribed a quorum of three members entitled to vote in the case of a public company and two members entitled to vote in the case of a private company. The concerns noted above regarding the King Committee's recommendation to increase quorum requirements for shareholders' meetings apply equally to the change made by s 64(1)(a). Notably s 64(2) provides that a company's MOI may specify a lower or higher percentage in place of the 25 percent required to satisfy the quorum requirements. The flexibility offered by

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<sup>192</sup> Ibid

<sup>193</sup> Ibid

<sup>194</sup> See C Rademeyer and J Holtzhausen op cit note 184 at 770

<sup>195</sup> Ibid at 771

this provision could be helpful for those companies that might find the 25% requirement too onerous albeit reducing the requirement to below 25% would run contrary to the rationale behind the change brought by s 64(1) regarding quorum requirements.

Shareholder meetings are a key platform for shareholders to influence corporate governance therefore it is critical that the law makes it as easy as possible and less costly for shareholders to participate at shareholders' meetings. In this regard s 63(2)(a) of the Act provides that unless the MOI of a company prohibits it, a company may provide for a shareholders' meeting to be conducted electronically.

The new Act also encourages shareholder activism by empowering shareholders to call for a shareholder's meeting; s 61(3) provides as follows:

‘Subject to subsection (5) and (6), the board of a company, or any other person specified in the company's Memorandum of Incorporation or rules, must call a shareholders meeting if one or more written and signed demands for such a meeting are delivered to the company, and-

(a) each such demand describes the specific purpose for which the meeting is proposed; and

(b) in aggregate, demands for substantially the same purpose are made and signed by the holders, as of the earliest time specified in any of those demands, of at least 10% of the voting rights entitled to be exercised in relation to the matter proposed to be considered at the meeting.’

The threshold of 10% of voting rights specified in s 61(3)(b) may be reduced but it cannot be increased by a company's MOI.<sup>196</sup> The 10% threshold is unlikely to be a difficult hurdle for institutional shareholders who usually hold a considerable number of shares in the companies they invest in, so they can easily satisfy the requirement acting singly or in concert with other institutional investors.<sup>197</sup> For instance, an announcement posted on the JSE Stock Exchange News Service (SENS) recently shows that two institutional shareholders namely, the Public Investment Corporation [hereafter the PIC] and the Bidvest Group limited [hereafter Bidvest], managed to compel the board of Adcock Ingram Holdings Limited to call a special shareholder's meeting in terms of s 61(3) and also to force the resignation of the chairman of the board.<sup>198</sup> According to the announcement the PIC and Bidvest held 21% and 34.5%

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<sup>196</sup> Section 61(4)

<sup>197</sup> FHI Cassim, MF Cassim, R Cassim et al op cit note 32 at 500

<sup>198</sup> See ‘ADCOCK INGRAM HOLDINGS LIMITED – Receipt of Section 61(3) notices from Bidvest and PIC and resignation of chairman’ Available at [http://www.moneyweb.co.za/mny\\_sens/adcock-ingram-holdings-limited-receipt-of-section-613-notices-from-bidvest-and-pic-and-resignation-of-chairman/](http://www.moneyweb.co.za/mny_sens/adcock-ingram-holdings-limited-receipt-of-section-613-notices-from-bidvest-and-pic-and-resignation-of-chairman/) Accessed on 31 March 2016

percent respectively of the shareholding in the company. For individual shareholders the 10% threshold could be difficult to meet.

In the USA there is an on-going debate concerning whether shareholders should have the right to call special shareholders' meetings without board approval and if so, what threshold of shares must be held by a shareholder to have the locus standi to call such a meeting.<sup>199</sup> The position varies amongst the states. In states such as California, shareholders have a statutory right to call a special shareholders' meeting. Section 600(d) of the California Corporations Code provides that,

‘Special meetings of the shareholders may be called by the board, the chairperson of the board, the president, the holders of shares entitled to cast not less than 10 percent of the votes at the meeting, or any additional persons as may be provided in the articles or bylaws.’

However, the law in Delaware, which is considered the leading corporate law jurisdiction in the USA, is less accommodating of shareholders in this regard. In terms of s 211(d) of the Delaware General Corporation Law generally only the board can convene a special meeting, but there is scope for the certificate of incorporation or by-laws of a corporation to authorise other persons – who may include shareholders – to call a special meeting.<sup>200</sup> Other states such as New York follow the Delaware law.<sup>201</sup> Hence in Delaware and New York shareholders do not have a statutory right to call a shareholders' meeting. In such states a shareholder would have to examine the by-laws of his/her target investment company to establish whether they permit shareholders to call a special meeting and the requirements that the shareholder would have to satisfy in that respect. This is unsatisfactory because a company's by-laws may allow shareholders to call a special meeting but then set stringent requirements which a shareholder has to satisfy in order to be able to call a shareholder's meeting and hence inhibit the ability of shareholders to have a say in the governance of a company.

Canada on the other hand is more permissive, s 143(1) of the Canada Business Corporations Act provides that,

‘The holders of not less than five per cent of the issued shares of a corporation that carry the right to vote at a meeting sought to be held may requisition the directors to call a meeting of shareholders for the purposes stated in the requisition.’

Similarly, s 249D of the Australian Corporations Act provides that:

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<sup>199</sup> JF Olson op cit note 105 at 243.

<sup>200</sup> Section 211(d) of the Delaware General Corporation Law

<sup>201</sup> See s 602(c) of the New York Business Corporation Law

‘The directors of a company must call and arrange to hold a general meeting on the request of:

- (a) members with at least 5% of the votes that may be cast at the general meeting; or
- (b) at least 100 members who are entitled to vote at the general meeting.’

Hence Canada and Australia make it easier than the South African Act for shareholders to call a special shareholders’ meetings by prescribing a lower threshold of 5% of the votes that may be cast. It could be said that s 249D(b) of the Australian Corporations Act also makes it easier for individual minority shareholders to call for a special meeting in public companies since the support of only 100 people, irrespective of the percentage of their shareholding in the company, is required to call such a meeting.

The enforcement provisions of the Act are also another attempt to enhance shareholder activism by reducing the costs associated with enforcing compliance with the Act. For instance, s 156 read with s 167 provide for the resolution of disputes through mediation, conciliation and arbitration. These methods of dispute resolution were enacted on the back of concerns that ‘the traditional method of resolving commercial disputes through adversarial litigation had become expensive, sluggish due to the high caseload in courts, and cumbersome as a result of the formalities required in terms of the court processes.’<sup>202</sup> These alternative dispute resolution methods [hereafter ADR] were geared to provide a simple, speedy and cost effective method of resolving disputes. However, the weakness of the ADR methods in the Act is that they are voluntary and parties cannot be compelled to participate in the proceedings. If a party refuses to participate the Tribunal or an accredited entity to which the dispute has been referred can only issue a certificate in terms of s 166(2) to the effect that the process has failed. Section 166(2) provides that:

‘If the Companies Tribunal, or an accredited entity, to whom a matter is referred for alternative dispute resolution concludes that either party to the conciliation, mediation or arbitration is not participating in that process in good faith, or that there is no reasonable probability of the parties resolving their dispute through that process, the Companies Tribunal or accredited entity must issue a certificate in the prescribed form stating that the process has failed.’

It is reported that because of the voluntary nature of the ADR proceedings under the Act one of the cases brought before the Tribunal could not proceed because one of the parties failed to attend and the Tribunal had to issue a certificate in terms of s 166(2)<sup>203</sup> In another case the

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<sup>202</sup> S Ntshangase ‘A shift from adversarial litigation of commercial disputes to alternative dispute resolution’ (2015) 3 *Companies Tribunal Bulletin*

<sup>203</sup> Ibid

proceedings could not continue because the respondent refused to give its consent for the matter to be resolved by ADR.<sup>204</sup>

Section 157(1)(c) of the Act appears to be a response to one of the recommendations in the King Report II in that it introduces the possibility of class actions in South African company law. Section 157(1)(c) provides that ‘when, in terms of this Act, an application can be made to, or a matter can be brought before, a court, the Companies Tribunal, the Panel or the Commission, the right to make the application or bring the matter may be exercised by a person acting as a member of, or in the interest of, a group or class of affected persons, or an association acting in the interest of its members.’ It is submitted that the possibility of class actions introduced by this section could potentially enhance shareholder activism by reducing the costs faced by individual shareholders in trying to ensure that directors comply with principles of good corporate governance. Further, a shareholder will have more confidence acting as part of a group.

Another factor which, in conjunction with the Act, is likely to enhance shareholder activism is the Code for Responsible Investing in South Africa [hereafter CRISA]. CRISA was issued by the Committee on Responsible Investing by Institutional Investors in South Africa which was established subsequent to the King II Report.<sup>205</sup> CRISA is applicable to institutional investors<sup>206</sup> and their service providers.<sup>207</sup> It is also proposed that foreign pension funds, insurance companies, investment trusts and other collective investment vehicles should apply CRISA to the extent that they invest in South African companies.<sup>208</sup> Like the King Code on Corporate Governance, CRISA is a non-mandatory market-based code of governance.

The purpose of CRISA is to ‘give guidance on how the institutional investor should execute investment analysis and investment activities and exercise rights so as to promote sound governance.’<sup>209</sup> Principle 2 of CRISA provides that, ‘an institutional investor should demonstrate its acceptance of ownership responsibilities in its investment arrangements and

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<sup>204</sup> Ibid

<sup>205</sup> See the Introduction to the *Code for Responsible Investing in South Africa* published by the Institute of Directors of South Africa (2011) Available at [https://www.icgn.org/sites/default/files/South%20African\\_Code.pdf](https://www.icgn.org/sites/default/files/South%20African_Code.pdf) accessed 29 March 2016

<sup>206</sup> The term institutional investor is defined in CRISA as ‘any legal person or institution referred to in the definition of “financial institution” in section 1 of the Financial Services Board Act No 97 of 1990, to the extent that these legal persons or institutions own and invest in the equity of a company and have obligations in respect of investment analysis, activities and returns to ultimate beneficiaries.’

<sup>207</sup> CRISA defines the term ‘service provider’ to mean ‘those who act under mandate of the institutional investor in respect of any of the investment decisions and investment activities dealt with in CRISA, including asset and fund managers and consultants’

<sup>208</sup> See the ‘Application’ section of CRISA

<sup>209</sup> Ibid under the heading ‘Purpose’



investment activities.’ This principle requires an institutional investor to demonstrate a responsible approach to shareholding by inter alia developing a policy that deals with mechanisms of intervention and engagement with the company when concerns have been identified and the means of escalation of activities as a shareholder if these concerns cannot be resolved. The policy should also specify the institutional investor’s approach to voting at shareholder meetings, including the criteria that are used to reach voting decisions and for public disclosure of full voting records. Principle 3 requires institutional investors to consider a collaborative approach to promote acceptance and implementation of the principles of CRISA and other codes and standards applicable to institutional investors. In this respect an institutional investor is enjoined to consider a cooperative approach to work jointly with other shareholders, service providers, regulators, investee companies and ultimate beneficiaries to, where appropriate, promote acceptance and implementation of CRISA and sound governance. It is noteworthy that these principles and practices contained in CRISA are also echoed in the King IV Code on Corporate Governance. For instance, the Code provides that,<sup>210</sup>

‘The governing body of an institutional investor organisation should ensure that responsible investment is practiced by the organisation to promote the good governance and the creation of value by the companies in which it invests.’

Like CRISA, the King IV Code also enjoins the governing body of an institutional investor to approve a policy that articulates its direction on responsible investment and this policy should provide for the adoption of a recognized responsible investment code, principles and practices.<sup>211</sup> Moreover the responsible investment code adopted by the institutional investor and the application of its principles should be disclosed.<sup>212</sup>

Thus CRISA as well as the King IV Code address some of the qualitative issues surrounding shareholder activism by prescribing reporting requirements for institutional investors concerning their engagement with their investee companies on corporate governance matters. Moreover, CRISA supported by the King IV Code play a significant role in educating institutional investors as to their role in corporate governance. To this extent CRISA complements the Act whose provisions are mainly geared towards the quantitative aspect of shareholder activism that is, getting more shareholders to participate in corporate

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<sup>210</sup> Institute of Directors Southern Africa ‘*King IV Code on Corporate Governance*’ (2016) Principle 17

<sup>211</sup> Institute of Directors Southern Africa ‘*King IV Code on Corporate Governance*’ (2016) Principle 17 – Recommended Practice 21

<sup>212</sup> Ibid – Recommended Practice 25

governance matters. Although CRISA is a voluntary code which does not have the force of law, it is supported by key role players in the market such the JSE and the Financial Services Board (FSB).<sup>213</sup> It is to be hoped that CRISA, the reporting requirements of which became effective on 1 February 2012,<sup>214</sup> will, alongside the King IV Code and the provisions of the Act, enhance shareholder activism in South Africa.

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<sup>213</sup> See the 'Acknowledgement' section of CRISA

<sup>214</sup> See the 'Application' section of CRISA

## CHAPTER 7: FINDINGS, RECOMMENDATIONS & CONCLUSION

### **7.1 Introduction**

This thesis set out to show where there has been a shift in the balance of power between shareholders and the board of directors in the new Act. It also sought to illustrate how this shift is potentially detrimental to shareholder protection and, to establish whether the new Act has balanced the shift in power with increased shareholder protection. In a bid to answer these questions this thesis considered the changes brought about by those provisions of the new Act which give, or appear to give, power to the board of directors and examined how the changes brought about by the Act impact on shareholder protection. The shareholder remedies contained in the new Act, as well as other measures designed to make directors accountable for the exercise of their powers, were critically examined to establish whether they adequately protect shareholders. The findings from this discussion are summarised below.

### **7.2. Shift of power & impact on shareholders**

The discussion in chapter two and three showed that the new Act has altered the default position concerning the division of powers by giving directors original power to manage the business and affairs of the company. This change does not necessarily amount to a shift in power in itself because under the old Act the articles routinely delegated the power to manage the business of the company to the board of directors.<sup>1</sup> Moreover the default position in s 66(1) can be still be changed via the MOI.

The division of powers provided for in s 66(1) is not necessarily a bad thing, especially for public companies. Generally public companies have a dispersed shareholding and therefore the arrangement whereby a board of directors manages the business and affairs of the company on behalf of the shareholders is optimal for such companies. However, s 66(1) may be a challenge for private companies who wish to establish a different division of powers. Changing the effect of s 66(1) via the MOI or a shareholders' agreement might not be easy because both the MOI and a shareholders agreement must be consistent with the Act, otherwise they could be invalidated in terms of s 15(1) and s 15(7) respectively. The

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<sup>1</sup> FHI Cassim, MF Cassim, R Cassim *et al Contemporary Company Law* 2ed (2012) at 403

challenge is that it is difficult to know in advance whether any proposed alternative governance arrangement in the MOI or in a shareholders' agreement would be considered inconsistent with the Act and therefore invalid. Hence there is a need to amend s 66(1) as recommended in paragraph 7.5.1 below in order to make it possible for companies, especially closely held private companies, to validly establish governance arrangements that meet their needs.

Chapter two and three showed that the new Act has shifted the balance of power between shareholders and directors by bestowing upon the latter power to authorise the issuing of shares in terms of s 38, the repurchase of its shares by a company in terms of s 48 and to authorise company distributions in terms of s 46. There is a shift in this regard because under the old Act the board did not, for example, have power to issue shares or authorise a share repurchase without prior shareholder approval. The new Act does not require a company to have authority in its MOI before it can enter into any of these transactions. Companies ought to have the flexibility to determine whether or not they want their directors to have these powers and if so, the conditions that should be attached to the exercise of those powers.

The protective measures in the new Act include the fact that the Act requires shareholder approval in certain prescribed circumstances regarding the issuing of shares<sup>2</sup> or share repurchases.<sup>3</sup> The pre-emptive right in s 39 is also another protective measure in the context of new share issues. However, this right only applies to private companies and personal liability companies but not to public companies.<sup>4</sup> There is need to amend the Act to ensure that it prescribes pre-emptive rights even for public companies.

The new Act does not adequately protect shareholders in the context of share repurchases. It does not make a distinction between general and selective offers by a company to repurchase its share. It also does not require companies to disclose information to shareholders to enable them to make informed decisions when faced with an offer to repurchase their shares. The provisions in the new Act which empower directors to issue shares and authorise distributions are unalterable provisions. Therefore there is very limited scope for companies to alter the effect of these unalterable provisions in terms of s

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<sup>2</sup> Section 41 of the new Act

<sup>3</sup> An exception to this general position is s 48(8)(a) of the new Act which requires approval of a share repurchase by a special resolution of the shareholders if any shares are to be acquired from a director or prescribed officer of the company or a person related to any of these persons.

<sup>4</sup> See section 39(1) & (2) of the new Act

15(2)(a)(iii). There is a risk that attempts to alter the effect of these provisions in the MOI or a shareholders' agreement may be invalidated in terms of s 15(1) or 15(7). It is crucial that companies be given the flexibility to decide whether or not they want their directors to have the power to issue shares or to authorise share repurchases and, if so, to determine the conditions under which those powers may be exercised. Hence there is need to amend the new Act as suggested in the recommendations section below.

### **7.3. Shareholder remedies and accountability of directors**

The discussion in chapter four of this thesis showed that the new Act attempts to make directors accountable by imposing certain duties upon the directors. However, these are ex-post facto measures that can only be used after the company has already suffered harm. Section 76(3)(c) which imposes on directors a duty of care, skill and diligence, is ambiguous and could be interpreted in such a way that the test of care and skill under it is similar to the overly subjective test at common law. There is need to amend s 76(3)(c) as suggested below so that it imposes a stricter test of care and skill.

There is an attempt in the new Act to make directors liable to the company, as well as to the shareholders, for certain acts or omissions. These include *inter alia* s 77 and s 218(2), as well as s 20(6) by means of which shareholders could recover damages from directors should the latter intentionally, fraudulently or due to gross negligence cause the company to do anything inconsistent with the Act or the MOI. However it was noted that the effect of these liability provisions is blunted by other provisions such as s 77(5) which make it possible for a director to apply to court to be excused from liability.

Chapters five and six discussed the various remedies available to shareholders under the new Act. It was noted that the new Act contains new and improved remedies. These include the remedy of having a director declared delinquent or placed under probation and the remedy against oppressive or prejudicial conduct which should prove useful to shareholders in holding directors accountable. However, the effectiveness of some remedies such as the derivative action in s 164 is hampered by certain procedural requirements such as, for example, the peremptory demand requirement set in s 165(2) and the rebuttable presumption that the granting of leave to bring a derivative action is not in the best interest of the company.<sup>5</sup> It was noted in chapter 6 that the effectiveness of the appraisal remedy contained in s 164 is hampered by the complex and technical procedural requirements that a shareholder

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<sup>5</sup> Section 165(7)

must satisfy to be entitled to exercise the remedy. The possible involvement of the court in the appraisal process could also result in delays and high costs of litigation which may inhibit small shareholders from exercising the remedy.

It was also noted in chapter six that the new Act empowers shareholders to appoint and remove directors in terms of ss 66 and 71. However the language used in s 71(1) read with s 66(4)(a)(i) appears to unduly limit the right of shareholders to remove directors that are directly appointed by persons named in the MOI in terms of s 66(4)(a)(i).

Although the new Act tries to balance the increased powers of directors through the use of directors' duties, imposition of civil liability on directors, as well as new and improved remedies, certain weaknesses in the Act which leave shareholders vulnerable to the abuse of directors' powers were identified in this thesis. Overall, it can be concluded from the discussion in chapters 2 to 6 that the changes brought about by the new Act have shifted the balance of power between shareholders and directors in favour of the latter, especially in the area of corporate finance. A comparison of various provisions of the Act with comparative provisions in foreign legislation showed that our law compares favourably with the law in foreign jurisdictions such as the USA, Canada, the UK, Australia and New Zealand on certain aspects. However, it was shown that some of the new changes brought about by the new Act leave shareholders exposed to the abuse of power by directors. Therefore there is room to enhance the protection of shareholders under the new Act. In this respect provisions from various foreign legislation that were considered in the comparative discussion can provide guidelines as to how our Act can be improved as recommended below.

## ***7.5.0 Recommendations***

### ***7.5.1 Recommendation on the division of power***

It is recommended that s 66(1) and s 15(7) of the new Act be amended by adopting wording similar to that found in s 8.01(b) read with s 7.32(a) respectively of the MBCA. The amended s 66(1) should read as follows:

66(1) Board, directors and prescribed officers

- (a) Except as provided in section 15(7), each company must have a board of directors.
- (b) The business and affairs of a company must be managed by or under the direction of its board, which has the authority to exercise all of the powers and perform any of the functions of the company, subject to any limitation set forth in the company's memorandum of incorporation or in an agreement authorized under section 15(7).

Section 15(7) of the new Act governing shareholders' agreements should also be amended to read as follows:

- (a) An agreement among the company's shareholders that complies with this section is effective among the shareholders and the company even though it is inconsistent with one or more other provisions of this Act in that it:
  - (i) eliminates the board of directors or restricts the discretion or powers of the board of directors;
  - (ii) governs the authorization or making of distributions whether or not in proportion to ownership of shares, subject to the limitations in section 46;
  - (iii) establishes who shall be directors or officers of the company, or their terms of office or manner of selection or removal;
  - (iv) transfers to one or more shareholders or other persons all or part of the authority to exercise the company's powers or to manage the business and affairs of the company, including the resolution of any issue about which there exists a deadlock among directors or shareholders;
  - (v) otherwise governs the exercise of the company's powers or the management of the business and affairs of the company or the relationship among the shareholders, the directors and the company, or among any of them, and is not contrary to public policy.
- (b) An agreement authorized by this section that limits the discretion or powers of the board of directors shall relieve the directors of, and impose upon the person or persons in whom such discretion or powers are vested, liability for acts or omissions imposed by law on directors to the extent that the discretion or powers of the directors are limited by the agreement.

The suggested amendment would ensure that a provision in a shareholders agreement could validly change the default division of powers in s 66(1), even in a manner that is inconsistent with the Act. This would provide flexibility for companies, particularly small closely held companies, to establish management structures that meet their specific needs in line with one of the purposes of the Act of 'creating flexibility and simplicity in the formation and maintenance of companies.'<sup>6</sup>

The new s 15(7)(a)(ii) would ensure that the directors' power to authorise distributions in terms of s 46 may be validly altered by a provision in a shareholders' agreement. Other suggested amendments to the new Act relating to distributions are discussed below.

The proposed s 15(7)(b) would ensure that the liability imposed by the law on company directors is appropriately assigned to the person or persons upon whom the

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<sup>6</sup> Section 7(b)(ii) of the new Act

shareholders' agreement confers the power to manage the business and affairs of the company in place of the board.

### **7.5.2 Recommendation on distributions to shareholders**

To give companies the flexibility to validly alter the effect of s 46, regarding the directors' power to authorise distributions, it is recommended that s 46(1) of the new Act be amended by adopting the wording in s 6.40 of the MBCA so that it reads as follows:

#### **46. Distributions to Shareholders**

(1)(a) A board of directors may authorize and the corporation may make distributions to its shareholders subject to any restrictions in the memorandum of incorporation and the limitations in subsections (b), (c) and (d).

(b) A company must not make any proposed distribution unless the distribution-

(i) is pursuant to an existing legal obligation of the company, or a court order; or

(ii) has been authorised by a resolution of the board in terms of paragraph (a) above and;

(c) it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution; and

(d) the board of the company, by resolution, has acknowledged that it has applied the solvency and liquidity test, as set out in section 4, and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution.

The proposed amendment, in particular the proposed s 46(1)(a) would make it clear that the power of directors to authorise distributions is subject to what is stated in the MOI. This empowers shareholders to determine what the directors may or may not do on behalf of the company in relation to distributions. It provides companies with greater scope for altering the effect of the current s 46 than would be possible in terms of s 15(2)(a)(iii) which, as noted in chapter 3<sup>7</sup>, limits the extent to which an unalterable provision such as s 46 can be altered by a provision in the MOI.

In addition to amending s 46(1), it is recommended that s 4(2)(c) of the new Act be amended by adopting wording similar to that contained in s 52(4) of the New Zealand Companies Act, 1993 in order to address the issue identified in chapter 3<sup>8</sup> concerning the protection of the interests of preference shareholders when applying the solvency and liquidity test. The amended s 4(2)(c) should read as follows:

(c) In applying the solvency and liquidity as required by this Act,

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<sup>7</sup> See para 3.4.3.1 of chapter 3

<sup>8</sup> Para 3.4.5 of chapter 3



- (i) debts includes fixed preferential returns on shares ranking ahead of those in respect of which a distribution is made (except where that fixed preferential return is expressed in the constitution as being subject to the power of the directors to make distributions), but does not include debts arising by reason of the authorisation; and
- (ii) liabilities includes the amount that would be required, if the company were to be deregistered after the distribution, to repay all fixed preferential amounts payable by the company to shareholders, at that time, or on earlier redemption (except where such fixed preferential amounts are expressed in the constitution as being subject to the power of directors to make distributions); but, subject to paragraph (i), does not include dividends payable in the future

It is also recommended that the definition of the term ‘distribution’ in s 1 of the Act be amended by the addition of a paragraph (d) to the definition. The proposed paragraph (d) should provide that, for the purposes of paragraphs (b) and (c), the term obligation includes both a monetary and non-monetary obligation. This amendment would close the loophole noted in chapter 3.<sup>9</sup>

### **7.5.3 Recommendation on share issues and pre-emption rights**

The limited extent to which unalterable provisions of the Act, such as s 38(1), can be restricted or qualified by the MOI in terms of s 15(2)(a)(iii) was highlighted in chapter 3. To get around the limitations of s 15(2)(a)(iii) it is recommended that s 38(1) of the new Act be amended so that the power of directors to issue shares is made subject to any restrictions in the MOI. The amended section should read as follows:

#### **38. Issuing shares**

(1) *Subject to any restrictions contained in a company’s memorandum*, the board of a company may resolve to issue shares of the company at any time, but only within the classes, and to the extent, that the shares have been authorised by or in terms of the company’s Memorandum of Incorporation, in accordance with section 36.

It is further recommended that ss 39(1) to (3) of the Act which govern the pre-emption right with regard to share issues be amended so that the pre-emption right in the new Act is made applicable to all profit companies and not just private and personal liability companies. The amended ss 39(1) to (3) could be based on s 45 of the New Zealand Act and should read as follows:

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<sup>9</sup> See discussion in para 3.4.4 in chapter 3

### 39 Pre-emptive rights

(1) Shares issued or proposed to be issued by a company that rank or would rank as to voting or distribution rights, or both, equally with or prior to shares already issued by the company must be offered for acquisition to the holders of the shares already issued in a manner and on terms that would, if accepted, maintain the existing voting or distribution rights, or both, of those holders.

(2) An offer under subsection (1) must remain open for acceptance for a reasonable time.

(3) A company's memorandum of incorporation may negate, limit, or modify the requirements of this section

## **7.5.4 Recommendations on share repurchases**

It is recommended that s 48(2)(a) of the new Act be amended so that it provides that:

‘Subject to section 46, a company may purchase or otherwise acquire shares issued by it if it is expressly permitted to do so by its memorandum of incorporation.’

The proposed amendment is based on an adaptation of s 58(1) of the New Zealand Companies Act, 1993. The terms of the amended s 48(2)(a) would enable a company to validly include a provision in its MOI that precludes the company from buying back its own shares or, impose restrictions on the exercise of the company's power to buy back its own shares. The amendment obviates the need to comply with the restrictive requirements of s 15(2)(a)(iii) when trying to limit, qualify or restrict the directors' power to authorise share repurchases via the MOI.

To protect shareholders against the abuse inherent in selective share repurchases as discussed in chapter 3, it is recommended that s 48 be further amended by the addition of a s 48(2)(A) requiring that selective offers to repurchase a company's shares must be approved by special resolution of the company's shareholders, and that the company disclose relevant information to shareholders. The proposed s 48(2)(A) would be based on an adaptation of s 257D of the Australian Corporations Act 2001 and would read as follows:

(1) Where a company offers to buy-back shares issued by it from 1 more of its shareholders, the terms of the buy-back agreement must be approved before it is entered into by either:

(a) a special resolution passed at a general meeting of the company, with no votes being cast in favour of the resolution by any person whose shares are proposed to be bought back or by their associates; or

(b) a resolution agreed to, at a general meeting, by all ordinary shareholders; or the agreement must be conditional on such an approval.

(2) The company must include with the notice of the meeting a statement setting out all information known to the company that is material to the decision as to how to vote on the resolution. However, the company does not have to disclose information if

it would be unreasonable to require the company to do so because the company had previously disclosed the information to its shareholders.

Apart from requiring disclosure in respect of selective repurchases, it is also recommended that s 48 be amended by the addition of a s 48(2)(B) which provides for a general disclosure requirement for any share buy-back offer as follows:

- (i) Before making an offer to any of its shareholders to buy-back any shares issued by it, a company must send to each shareholder a disclosure document that complies with sub-section (2) of this section.
- (ii) For the purposes of sub-section (1), a disclosure document is a document that sets out—
  - (a) the nature and terms of the offer, and if made to specified shareholders, to whom it will be made; and
  - (b) the nature and extent of any relevant interest of any director of the company in any shares the subject of the offer; and
  - (c) any such further information and explanation as may be necessary to enable a reasonable shareholder to understand the nature and implications for the company and its shareholders of the proposed acquisition.

The proposed s 48(2)(B)(i) is based on an adaptation of s 61(5) of the New Zealand Companies Act of 1993 while s 48(2)(B)(ii) is based on an adaptation of s 62 of the same Act. The requirement for a disclosure document would facilitate transparency and also empower shareholders to protect their interests by ensuring that they are provided with adequate information to enable them to make informed decisions in the context of selective share repurchases.

### ***7.5.5 Recommendations on the derivative action***

To address the concerns noted in chapter 5 regarding the derivative action such as, the role of the board and, procedural concerns such as the demand requirement and, the rebuttable presumption that the granting of leave is not in the best interests of the company, it is recommended that the derivative action be streamlined and placed under the control of a neutral body – the courts. In particular, it is recommended that s 165 of the Act be amended and recast along the lines of s 261 of the UK Companies Act 2006 which reads as follows:

“(1) A member of a company who brings a derivative claim under this Chapter must apply to the court for permission to continue it.

(2) If it appears to the court that the application and the evidence filed by the applicant in support of it do not disclose a prima facie case for giving permission (or leave), the court—

- (a) must dismiss the application, and

- (b) may make any consequential order it considers appropriate.
- (3) If the application is not dismissed under subsection (2), the court—
  - (a) may give directions as to the evidence to be provided by the company, and
  - (b) may adjourn the proceedings to enable the evidence to be obtained.
- (4) On hearing the application, the court may—
  - (a) give permission (or leave) to continue the claim on such terms as it thinks fit,
  - (b) refuse permission (or leave) and dismiss the claim, or
  - (c) adjourn the proceedings on the application and give such directions as it thinks fit.”

### ***7.5.6 Recommendations on liability for share issues and distributions***

There is a need to rationalise the liability of directors in terms of s 77(3)(e) and the orders which a court may make in terms of s 77(5). The rationalisation is required to address the anomalous situation whereby a court could order a company, in terms of s 77(5), to indemnify a director who was present at a meeting, but who failed to vote against a decision taken at that meeting authorising inter alia a share issue or, a distribution where the director knew the transaction was contrary to or inconsistent with the Act. In this respect it is recommended that s 77(5) be amended by the deletion of paragraph b(ii)(bb).

### ***7.5.7 Recommendations on s 76(3)(c): duty of care, skill and diligence***

To address the ambiguity in s 76(3)(c) and also to ensure that the statutory duty imposes a stricter standard of care and skill on company directors it is recommended that the section be amended along the lines of the South African Banks Act 94 of 1990 so that it should read as follows:

- ‘A director of a company, when acting in that capacity, must exercise the powers and perform the functions of director with the degree of care, skill and diligence that may reasonably be expected of a diligent person-
- (i) carrying out the same functions in relation to the company as those carried out by that director; and
  - (ii) who possesses the general knowledge, skill and experience that may reasonably be expected of a person holding a similar appointment and carrying out similar functions as are carried out by the director and any such additional knowledge and skill as the director in question may have.’

### ***7.5.8 Recommendations concerning the appraisal remedy***

The recommendations that follow below are meant to provide guidelines as to how s 164 could be amended in order to enhance the effectiveness of the appraisal remedy. Obviously incorporating the suggested changes would call for a relook of the whole of s 164 to ensure coherence throughout all its provisions. However, it is not intended to provide here a comprehensive presentation of how the complete and amended s 164 should read.

In order to provide clarity concerning the standing of beneficial shareholders with regard to the appraisal remedy it is recommended that s 164 be amended by the addition of a new s 164(3)(A) modeled along the lines of s 13.03 of the MBCA. Subparagraph (a) of the new s 164(3)(A) would permit a registered shareholder who holds shares on behalf another – the beneficial shareholder – to assert appraisal rights on behalf of the beneficial shareholder. The provision should also make clear that the registered shareholder is allowed to assert the right on behalf of the beneficial shareholder only if he objects with respect to all shares of the class or series owned by the beneficial shareholder. This restriction serves to curb abuse of the appraisal remedy by beneficial shareholders who may seek to sell some, but not all, of their shares in the hope of extracting a higher price for their shares out of the appraisal process when they are in principle not against the triggering transaction.<sup>10</sup> The provision should also require the registered shareholder who demands appraisal on behalf of a beneficial shareholder to notify the company of the name and address of the beneficial shareholder on whose behalf the demand is made.

Subparagraph (b) of the new s 164(3)(A) would permit the beneficial shareholder to assert appraisal rights as to shares of any class or series held on his behalf if the beneficial shareholder submits to the company the registered shareholder's written consent to the assertion of such rights and if he does so with respect to all shares of the class or series that are held on his behalf by the registered shareholder.

The amendment suggested above would not only clarify the position of beneficial shareholders but, it would also bring internal coherence within the Act. Section 56(1) of the new Act permits, subject to a company's MOI, the shares of a company to be held by, and registered in the name of, one person for the beneficial interest of another person. This is in

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<sup>10</sup> See Official Commentary on s 13.03(a) of the MBCA

line with modern commercial practice.<sup>11</sup> In the light of this it would be odd if the Act did not clarify the position of beneficial shareholders regarding the exercise of the appraisal right.

With regard to the procedural requirements of the appraisal remedy, it was noted that a shareholder who fails to comply with the time periods prescribed by s 164 loses his appraisal right and that such a shareholder would not be saved by the substantial compliance provisions of the Act.<sup>12</sup> To address this and, to prevent a situation where a shareholder could lose his appraisal right because of a minor deviation from the statutory procedure, it is recommended that s 164 be amended so that the court is given a discretion to condone non-compliance with the statutory requirements where the deviation from procedure causes little or no harm to the company.<sup>13</sup>

With regard to the issue of costs and delays associated with pursuing the appraisal right in court as discussed in chapter 6, it is imperative that our Act be improved by including a provision requiring a company to make a preliminary payment to the dissenting shareholders pending a determination of the fair value of the concerned shares by the court or an arbitrator. In this respect s 164(11) should be substituted by a provision modelled on s 13.24 of the MBCA requiring the company to pay in cash to all the shareholders who complied with the requirements of subsections (3) to (5) the amount which the company estimates to be the fair value of their shares, plus interest. The proposed provision should also inform the qualifying shareholders that if they are dissatisfied with the amount offered by the company they have a right to demand further payment under the proposed subsection (12) (see discussion in the next paragraph) and, that if any such shareholder does not do so within the time period specified therein, such shareholder shall be deemed to have accepted such payment in full satisfaction of the company's obligations

Of course the inclusion of the suggested s 164(11) would necessitate amendments to other provisions of s 164 in order to remove references to an offer in terms of subsection (11). For example, subsection (12) would have to be repealed because then the offer envisaged in that provision would have fallen away. It is recommended that subsection (12) be substituted by a new provision modelled on s 13.26 of the MBCA which would spell out the procedure to

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<sup>11</sup> Harry Sutherland, David B Horsely, Graham Turner et al '*Fraser & Stewart Company Law of Canada*' 6ed (1993) at 575-576

<sup>12</sup> See discussion in para 6.5

<sup>13</sup> Jacqueline Yeats 'The effective and proper exercise of appraisal rights under the South African Companies Act, 2008: developing a strategic approach through a study of comparable foreign law' (Unpublished PhD thesis, UCT 2016) at para 7.5.1.4

be followed if a shareholder is dissatisfied with the payment made in terms of the new s 164(11). The new s 164(12) should provide as follows:

- (i) A shareholder paid pursuant to section 164(11) who is dissatisfied with the amount of the payment must notify the company in writing of that shareholder's estimate of the fair value of the shares and demand payment of that estimate plus interest (less any payment under section 164(11))
- (ii) A shareholder who fails to notify the company in writing of that shareholder's demand to be paid the shareholder's stated estimate of the fair value plus interest under paragraph (i) within 30 days after receiving the company's payment under section 164(11) waives the right to demand payment under this section and shall be entitled only to the payment made in terms of section 164(11).

The advantages of arbitration over litigation in the context of appraisal rights were discussed in chapter 6 and it was shown that arbitration could address some of the issues such, as the costs and delays associated with litigation. Therefore it is recommended that subsection (14) of s 164 be amended to provide for the determination of the fair value of shares by arbitration. The proposed s 164(14) should be modelled along the lines of s 112A(1) of the New Zealand Companies Act and should read as follows:

If a shareholder is dissatisfied with the amount paid by the company and, the shareholder makes a demand for payment under subsection (12) which remains unsettled the company shall submit the issue of the fair value of the shares for determination by arbitration.

### **7.5.9 Recommendations on removal of directors**

To ensure that a company may remove directors, whether appointed or elected, by ordinary resolution of the shareholders, it is recommended that s 71(1) of the new Act be amended as shown below:

- (1) Despite anything to the contrary in a company's Memorandum of Incorporation or rules, or any agreement between a company and a director, or between any shareholders and a director, a director may be removed by an ordinary resolution of the company's shareholders ~~adopted at a shareholders meeting by the persons entitled to exercise voting rights in an election of that director~~, subject to subsection (2).
- (2) Before the shareholders of a company may consider a resolution contemplated in subsection (1)-
  - (a) the director concerned must be given notice of the meeting and the resolution, at least equivalent to that which a shareholder is entitled to receive, irrespective of whether or not the director is a shareholder of the company; and
  - (b) the director must be afforded a reasonable opportunity to make a presentation, in person or through a representative, to the meeting, before the resolution is put to a vote.

(c) If the director was appointed by a person named in a company's memorandum of incorporation in terms of s 66(4)(a)(i), the resolution to remove the director does not take effect until that person appoints another director to replace the director who is being removed.

Deleting the words that are struck out in (1) above from the current s 71(1) would eliminate the ambiguity in that provision as to whether directors appointed by in terms of s 66(4)(a)(i) can be removed by ordinary resolution of the shareholders. The proposed new s 71(2)(c) would ensure that the interests of the party who has the right to directly appoint a director in terms of s 66(4)(a)(i) are protected in the event that the appointed director is removed by ordinary resolution of the shareholders.

It is hoped that the adoption of the above recommendations would enhance the protection of shareholders in light of the increased powers of directors. A key feature of the new Act was to provide flexibility in the management of companies, most of the proposed changes would provide greater flexibility for companies to establish governance arrangements that meet their needs in their MOIs or, by means of shareholders' agreements, without worrying about contravening the provisions of the new Act.



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